Supreme Court, U.S.
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No. ____

In The

Supreme Court of the United States

October Term, 1996

ROBERT C. MILLER, CHARLES BOESENBERG, DAVID G. LUDVIGSON, and MIPS COMPUTER SYSTEMS, INC.,

Petitioners,

v.

DIANE PROVENZ and AHIKIM EIZENBERG, On Behalf of Themselves and All Others Similarly Situated,

Respondents.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Under Section 10(b) of the Securities Exchange Act of 1934, is recklessness sufficient to satisfy the scienter requirement and, if so, is it necessary to show at least subjective recklessness – bad faith.

2. In an accounting fraud case brought under Section 10(b) of the Securities Exchange Act of 1934, is summary judgment appropriate:

   a. Where generally accepted accounting principles permitted a range of revenue recognition practices that included the company's practice, the company's auditors approved its practice, and the challenged revenue was collected; and

   b. Where plaintiffs' opposition hinged on the testimony of experts, who merely opined that they would have accounted for the challenged revenue differently from the company and its auditors, without identifying an authoritative accounting standard that was violated.

OTHER PARTIES

In addition to petitioners, Stephen Bennion and William Jobe appeared as defendants-appellees before the Ninth Circuit below.

DISCLOSURE PURSUANT TO RULE 29.1

Petitioner MIPS Computer Systems, Inc. states that, in June 1992, it was acquired and merged into Silicon Graphics, Inc., whose stock is publicly traded on the New York Stock Exchange. Soon thereafter, certain assets of MIPS Computer Systems, Inc. were acquired by MIPS Technologies, Inc., which is a wholly-owned subsidiary of Silicon Graphics, Inc.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit (Pregerson, J.), affirming in part and reversing in part the district court's grant of summary judgment for petitioners, is reported at 102 F.3d 1478 (9th Cir. 1996), and is reprinted as Appendix A, at page A1. (References to the appendices bound with this Petition are styled ("A___"). The opinion of the United States District Court for the Northern District of California, from which appeal was taken, is reported at [1994-95 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,347 (N.D. Cal. 1994), and reprinted as Appendix C, at page A76.

JURISDICTION

The decision of the court of appeals issued on September 11, 1996 (reprinted as Appendix B, at page A39), was withdrawn and amended on December 18, 1996. A timely petition for rehearing and suggestion for rehearing *en banc* was denied on February 4, 1997. (Appendix D, at page A94). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This case presents questions of statutory interpretation involving Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5. Section 10(b) provides in relevant part:

> Section 10. Regulation of the Use of Manipulative and Deceptive Devices
>
> > It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5, provides:

> 10b-5. Employment of Manipulative and Deceptive Devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange –
>
> i) To employ any device, scheme or artifice to defraud,
>
> ii) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> iii) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

I. Proceedings in the District Court

This case is a securities fraud class action arising under Sections 10(b) and 20(a) of the Securities Exchange

Act of 1934 against MIPS Computer Systems, Inc. ("MIPS"), and certain of its officers.[1] The class consists of all persons who purchased MIPS common stock between February 6, 1991, and October 9, 1991. The central issue in the case is whether MIPS recognized revenue prematurely under generally accepted accounting principles ("GAAP") and, if so, whether MIPS' accounting decisions were made with scienter, as required by Section 10(b) and Rule 10b-5.

MIPS designed Reduced Instruction Set Computing ("RISC") microprocessors, and made computer workstations based on its RISC architecture. In addition to selling computer workstations, MIPS licensed its RISC technology to major computer companies for use in their products. On October 10, 1991, MIPS announced that its financial results for the third quarter of 1991 (ended, September 30, 1991) would be below Wall Street's expectations. In response to this disclosure, the price of MIPS common stock declined modestly from $10 to $8.50 per share, but fully recovered within two days.

In March 1992, MIPS announced that it would merge with Silicon Graphics, Inc. One week later, plaintiffs filed this lawsuit. Plaintiffs' principal fraud claim is that MIPS recorded revenue from its technology licensing contracts too soon, notwithstanding that MIPS collected virtually all of the recorded revenue and concluded, based upon contemporaneous discussions with its auditors, Ernst & Young, that revenue recognition in this esoteric area of accounting was proper. Plaintiffs contend that MIPS should not have recognized revenue before transferring

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[1] At all relevant times, the individual petitioners were MIPS officers: Robert Miller was MIPS' Chief Executive Officer; Charles Boesenberg was President; and David Ludvigson was Chief Financial Officer.

certain "deliverables" to its customers.[2] Plaintiffs also contend that MIPS recognized revenue under agreements that were subject to material contingencies. In addition, plaintiffs allege that MIPS made statements concerning its financial prospects, and the performance of one product line, that were fraudulent.

In a thorough opinion, U.S. District Judge Ronald M. Whyte granted petitioners' motion for summary judgment, finding that "[t]he evidence fails to raise a material issue of fact on the issue of *scienter*." (A76) (emphasis added). The cornerstone of the district court's analysis of the accounting claims was this Court's decision in *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), where the Court recognized that " 'generally accepted accounting principles are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions . . . [and instead] tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management.' " (A81). The district court found this statement compelling because "[n]o accounting literature in effect during the class period explicitly addressed revenue recognition under technology licensing agreements." (A85).

In support of their opinion, plaintiffs' experts relied extensively on accounting literature relating to the supposedly "analogous" licensing of computer software. This literature, however, acknowledged that "*authoritative literature provides no specific guidance on when to recognize revenue* on licensing or . . . sales . . . [even of] computer software," and that many accountants thought that "delivery [of deliverables] is not a key event" in the

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[2] "Deliverables" consisted of documents describing the licensed technology and a computer tape containing programs and databases.

revenue recognition process. (A96-97) (emphasis added).[3] Based upon the absence of a clear-cut standard governing the licensing of computer software, this literature also recognized that companies were using "a wide range of revenue recognition practices," which "[may] represent[] diverse application of . . . (GAAP) in the same circumstances." (Appendix E, at A96) (American Institute of Certified Public Accountants Proposed Statement of Position 91-1 (issued, Jan. 1991) ("Proposed SOP 91-1")). The district court found that MIPS' practice, recognizing revenue after a customer signed an agreement but before the final transfer of all contract deliverables, was within the range of acceptable industry practice, and thus "appears to have basically been consistent with its own written policy on the subject and GAAP."[4] (A83).

The district court did not merely rely upon its finding that MIPS' accounting appeared to comply with GAAP. Rather, the district court scrupulously reviewed the record *as a whole* to determine "whether as of the time of the alleged fraud, defendants' statements or omissions were made in bad faith given the circumstances then apparent to defendants." (A80). Because there was no

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[3] *See* Appendix E, at A98 (American Institute of Certified Public Accountants Statement of Position 91-1) (issued, Dec. 1991) (companies using "a wide range of revenue recognition practices," which include recognizing revenue on contract signing).

[4] MIPS' revenue recognition policy, as stated in its Form 10-K, provided that "[r]evenue recognition under technology agreements is *dependent upon the nature and level of efforts required to deliver and or support the technology transfer*" and that "[g]enerally revenue is recognized upon the completion of contract requirements." (ER 172/139:F-6) (emphasis added). The district court did not find that this policy required the transfer of technology deliverables before revenue recognition, but that revenue recognition "depende[d] upon the nature and level of efforts" required to transfer the deliverables. (A83).

evidence of subjective bad faith, the district court concluded that plaintiffs did not satisfy the scienter requirement of Section 10(b): "if plaintiffs papers are stripped of their harsh rhetoric they illustrate, at most, a difference of opinion as to when revenue should have been recognized. The facts do not justify a reasonable inference of fraudulent intent. . . . " (A81). The literature cited by plaintiffs' experts, on its face, demonstrated that GAAP embraced a range of acceptable revenue recognition practices, including MIPS' practice. Thus, the court determined that it "is not required to defer to the conclusions and subjective contrary opinions of litigation experts formed with the vision of 20/20 hindsight" because they lacked a valid factual basis. (A80).

The district court found that several undisputed facts strongly negated any finding of bad faith. It found that petitioners "voluntarily consulted" with Ernst & Young on a quarterly basis to ensure that revenue recognition complied with GAAP, and "recognized on several occasions less revenue than its controller originally believed should be recognized." (A81-82). The district court found this to be persuasive evidence of petitioners' good faith. *Id.*

The district court rejected plaintiffs' experts' opinion that MIPS fraudulently recognized revenue on agreements that were subject to contingencies – none of which ever occurred. The "major" contingency identified by plaintiffs' experts in certain contracts was a provision requiring Japanese government approval. Plaintiffs' experts opined that this was a material contingency precluding revenue recognition. The experts, however, could not identify a single instance in which the Japanese government had refused to allow a Japanese company to import American technology. Moreover, based upon years of experience licensing technology to Japanese companies, petitioners were unaware of any instance in which the Japanese government had ever denied such approval. Thus, the district court concluded that there

was no evidence to question "*MIPS belie[f]* at the time it recognized the revenue that the government approval process was a ministerial act and therefore the potential for non-approval was remote." (A84) (emphasis added).

With respect to other alleged contingencies, the district court concluded that "the evidence does not establish that *MIPS* did not reasonably believe that the contracts were binding when made." *Id.* (emphasis added). For example, certain contracts between MIPS and NEC were first recorded as purchase orders signed by a senior NEC official with whom petitioners had transacted business over a period of several years; later, more formal agreements were drafted. The district court found that petitioners in good faith believed that the purchase orders – which "state explicitly that NEC 'agrees' to pay a 'non-recoverable license fee' " – were binding contracts, which they proved to be. *Id.*

In sum, the district court concluded that "[t]he fact that income was fully realized from the transactions for which plaintiffs claim revenue was recognized early negates an inference of scienter." (A82). Consistent with its finding of petitioners' good faith, the district court noted, "[o]f the nearly $40,000,000 in technology revenue recorded during 1991, all but about one percent was paid and the one percent was fully reserved." *Id.*

As to the false forecasting claims, the district court found that plaintiffs had "pulled isolated statements out of context"; it did not find any evidence that petitioners had "lied" to the market or "were hiding adverse facts." (A87-88). As to the second quarter, the district court held that a *superseded* preliminary internal spreadsheet could not create a triable issue of scienter, where MIPS' public forecast was consistent with its internal forecast. *Id.* The district court found that petitioners had actually disclosed the allegedly undisclosed problems with one product (the R6000), its critical supply problem. (A89).

Finally, the district court found that the individual petitioners' stock sales did not establish scienter: "neither

the time nor the amount of the sales support a finding of scienter and are consistent with defendants' innocent explanations" and, thus, these sales cannot "reasonably lead to an inference of bad faith." (A90-91). Ludvigson, the Chief Financial Officer and supposed architect of the accounting fraud, sold only 3,265 of 66,000 available shares, fewer shares than in the prior year. Chief Executive Officer Miller sold 75,000 shares in early May 1991, to pay taxes – only 19 percent of his holdings. Miller sold 107,000 shares at the same time in 1990 for the same reason. President Boesenberg had an uncontroverted practice of selling all stock options six months after they vested. (A90-91).

II. Proceedings in the Court of Appeals

The Ninth Circuit, in an opinion authored by Circuit Judge Pregerson, affirmed in part and reversed in part. Although there was no governing standard in the evolving area of accounting for technology licenses, the Ninth Circuit held that the testimony of plaintiffs' accounting experts that they would have made different accounting decisions created a triable issue as to scienter. (A28). In particular, the Ninth Circuit found that the experts created a triable issue as to whether MIPS should have recorded revenue before transferring all deliverables, and whether contingencies such as government approval were material.[5] (A12).

The Ninth Circuit also found a triable issue of scienter as to MIPS' second quarter forecast. Pointing to the superseded internal spreadsheet, the Ninth Circuit held

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[5] The Ninth Circuit affirmed summary judgment as to three allegations. It held that there was no evidence that MIPS' forecast for the third quarter of 1991 was false; that MIPS' accounting for a major restructuring charge and other miscellaneous accounting transactions was improper; and no evidence that two officer defendants acted with scienter. (A30).

that "a reasonable trier of fact could conclude that defendants' forecasts or projections of a profit in the second quarter were unreasonable in light of the internal forecasts which indicated a loss for the second quarter." (A22).[6] The Ninth Circuit originally found that MIPS' third quarter forecast was actionable. The court later changed its ruling in response to a motion for rehearing showing that MIPS had disclosed that it expected a substantial quarterly loss.

The Ninth Circuit found that the individual petitioners' stock sales constituted circumstantial evidence of scienter. Although it acknowledged that Ludvigson's sales were "too minimal to suggest insider trading," it incongruously held that his participation in the challenged accounting created a genuine issue that he "knew or should have known of alleged fraud." (A31). As to Miller and Boesenberg, the Ninth Circuit ignored their uncontroverted reasons for selling stock and their prior patterns, which were inconsistent with bad faith, and simply relied on the dollar amount of their sales. (A30).

REASONS FOR GRANTING THE WRIT

Private securities fraud class actions under Section 10(b) have become a common occurrence in "Silicon Valley" when a technology company such as MIPS reports disappointing financial results. Many of these cases involve accounting fraud allegations. The Securities and Exchange Commission ("SEC") recently reported that accounting fraud was alleged in 43 percent of newly-filed private securities class actions.[7] Thus, this case raises two

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[6] Although the Ninth Circuit acknowledged that petitioners had *disclosed* serious sourcing and supply problems with the R6000 product, and that MIPS could not ship it, the Ninth Circuit still found a triable issue of scienter. (A23-24).

[7] The Securities and Exchange Commission, Office of the General Counsel, *Report to the President and the Congress on the*

core issues that arise in case after case. The first issue is whether recklessness is sufficient to satisfy the scienter requirement of Section 10(b), particularly in accounting cases involving GAAP, which "tolerates a range of 'reasonable' treatments." *Thor Power Tool*, 439 U.S. at 544. The second and equally important issue is whether a plaintiff can demonstrate scienter, under any formulation, where the plaintiff fails to establish the violation of any GAAP standard and the challenged practices fall within industry practice.

This Court has not definitively addressed whether mere recklessness is actionable under Section 10(b). In *Ernst & Ernst v. Hochfelder*, this Court expressly reserved the question "whether, in *some* circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." 425 U.S. 185 (1976) (emphasis added). Since *Hochfelder*, lower courts have applied some form of a recklessness test in *all* cases arising under Section 10(b). The application of varying approaches to recklessness and scienter by these courts has resulted in conflicting scienter standards and disarray. Some courts, such as the Ninth Circuit, have effectively applied an "objective" recklessness standard, in which the defendant's actual state of mind is irrelevant. Under that standard, liability turns on whether the defendant acted with sufficient care and diligence. Other courts, such as the Second Circuit, have required a plaintiff to show "conscious misbehavior" or at least "subjective" recklessness. Under a subjective standard, the defendant's actual state of mind is determinative, and the inquiry is whether the defendant acted in good or bad faith.[8] These conflicting

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First Year of Practice Under the Private Securities Litigation Reform Act of 1995 (Apr. 1997) ("SEC Report").

[8] The difference between an objective and a subjective standard has been recognized by the Court as critical in several different contexts. *See Farmer v. Brennan*, 511 U.S. 825, 838-40, 839 (1994) (basis for analysis of the "deliberate indifference"

scienter standards have led to inconsistent and unpredictable results. The formula most commonly recited by the lower courts is "malleable enough to support virtually any conclusion,"[9] as evidenced by the fact that it has been cited in support of both "objective" and "subjective" standards.

Congress' recent enactment of the Private Securities Litigation Reform Act of 1995, Pub. L. N. 104-67, 109 Stat. 737, only spotlights the importance of this issue. Although Congress mandated that the state of mind required under Section 10(b) for *forward-looking* statements is "actual knowledge," 15 U.S.C. § 78 u-5(c)(1) & (B), it did not expressly legislate in other parts of this statute. Section 10(b) claims based on allegedly false statements of historical fact, such as reported financial results, are subject to the divergent recklessness standards applied by the lower courts after *Hochfelder*.[10] Thus, the conflict among the lower courts will only become more acute as they face increasing numbers of accounting

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requirement under 42 U.S.C. § 1983: standard requiring "conscious" disregard focuses "on what a defendant's mental attitude actually was (or is), rather than what it should have been (or should be)"); *Harte-Hanks Communications, Inc. v. Connaughton*, 491 U.S. 657, 689 (1989) (mental state necessary to show "actual malice" in public figure defamation cases). In criminal law, the distinction between an objective test is viewed as "one of the most critical to criminal law." Paul H. Robinson, *A Brief History of Distinctions in Criminal Culpability*, 31 Hastings L.J. 815, 819-20 (1980).

[9] Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. Cin. L. Rev. 667, 688 (1991).

[10] Indeed, the SEC has taken the position that recklessness is the appropriate scienter requirement under Section 10(b) for non-forward looking statements. SEC Report at 41-42. The SEC, in fact, has intervened as *amicus curiae* in a recently-filed case in order to argue this point. *Id.*

fraud claims under Section 10(b), and struggle to resolve the question left undecided in *Hochfelder*.

In cases involving a judgment-laden area, such as accounting, the question surrounding the appropriate scienter standard takes on added significance, as courts will likely reach different results depending upon which standard is applied. This case is a prime example. Both the district court and Ninth Circuit purported to follow the recklessness standard adopted in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990). Nonetheless, they took radically different approaches and reached different conclusions.

The district court's opinion focussed on petitioners' actual state of mind, and whether plaintiffs' evidence established "bad faith." (A80). For example, in response to plaintiffs' government approval contention, the district focussed on petitioners' experience and the absence of evidence contradicting petitioners' belief that approval was a "ministerial act" and that "the potential for non-approval was remote." (A84). Evidence that approval was obtained in each instance merely confirmed the accuracy of petitioners' belief. The district court also considered evidence of petitioners' state of mind based upon the practices and procedures that MIPS followed with long-standing customers. *Id.* Thus, the district court did not draw any inference of fraudulent intent from MIPS' practice of recording revenue based upon purchase orders from NEC, a major customer, and later following up the purchase orders with more formalized and detailed agreements. *Id.* Also, the district court found no evidence of intent to defraud from defendants' stock sales, particularly with respect to petitioner Ludvigson, who sold an insignificant amount of stock, as well as with respect to petitioners Miller and Boesenberg, whose sales were entirely consistent with prior patterns. (A90-91). Finally, the district court found it difficult to quibble with petitioners' conduct when MIPS collected almost all of the

revenue that plaintiffs' experts contended was fraudulently recorded. (A82-83).

In contrast, the Ninth Circuit followed a rigid objective approach, pursuant to which it disregarded any evidence that bore upon petitioners' actual state of mind. For example, nowhere in Judge Pregerson's opinion did the court even mention that government approval had always been obtained in the past and was, in fact, obtained in connection with each challenged transaction. The Ninth Circuit also did not mention MIPS' long-standing practices with companies such as NEC, or even that MIPS collected almost all of the challenged revenue – a fact that would appear to confirm the propriety of petitioners' and Ernst & Young's judgment that revenue recognition on the transactions at issue was proper. Finally, the Ninth Circuit did not even mention that Miller and Boesenberg's stock sales were entirely consistent with prior trading practices, while it affirmed summary judgment in favor of two other MIPS officers, who, in its view, "sold their stock for innocent reasons." (A30). Instead, the Ninth Circuit relied on the opinion of plaintiffs' experts, who testified that they would have accounted for the challenged transactions differently, and that, notwithstanding the approval of Ernst & Young (not named as a defendant or accused of even negligence) there was no room for disagreement among professional accountants as to how these transactions should have been recorded. Because the applicable scienter standard may affect the outcome of this and numerous other accounting fraud cases, this writ should be granted to resolve the conflict among the lower courts and to establish a clear standard to be applied in all cases.

Regardless of the applicable scienter standard, summary judgment in favor of petitioners should have been affirmed under principles previously established by this Court. This case presents the question of whether summary judgment is appropriate in an accounting fraud case brought under Section 10(b), where GAAP permitted a

range of revenue recognition practices that included the company's practice, the company's auditors approved its practice, and the challenged revenue was collected. It also presents the question whether the unsupported testimony of accounting experts, which failed to identify an authoritative GAAP standard that was violated, and demonstrated a mere difference of accounting opinion, raise a triable issue of scienter. If the Ninth Circuit is correct that accounting experts may create a triable issue as to scienter on this record, no company will obtain summary judgment in an accounting fraud case.

I. The Court Should Decide What Constitutes "Scienter" Sufficient to Support Liability Under Section 10(b) of the Securities Exchange Act of 1934.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that "scienter" – defined as an "intent to deceive, manipulate, or defraud" – is required for civil liability under Section 10(b). *Id.* at 192 n.7, 193. In rejecting negligence as a basis for Section 10(b) liability, the Court concluded that the language of the statute proscribed only "knowing or intentional misconduct." *Id.* at 197-99. Since *Hochfelder*, the Court has repeatedly reaffirmed that knowing or intentional misconduct is necessary for an action to lie under Section 10(b).[11]

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[11] *See, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) (reaffirming *Hochfelder* and emphasizing that the "language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception"); *Aaron v. SEC*, 446 U.S. 680, 690, 694-95 (1980) (*Hochfelder* scienter requirement of "knowing or intentional misconduct" applies to SEC civil enforcement actions under § 10(b)); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983) (plaintiff in § 10(b) action "must prove that the defendant acted with scienter, i.e., with intent to deceive, manipulate, or defraud"). *See also Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 174 (1994) (discussing *Hochfelder* and

In *Hochfelder*, the Court reserved the question whether "in some circumstances" recklessness might be sufficient to show "an intent to deceive, manipulate or defraud." *Id.* at 194 n.12. As discussed below, there are substantial grounds for concluding that recklessness should *not* suffice under the statutory analysis set out in *Hochfelder*. Even if the Court were to decide otherwise, however, liability should be limited to "subjective" recklessness – bad faith – which the common law of deceit recognized as "a form of intentional conduct." *Id.*

Neither Section 10(b) itself, nor the Court's reasoning and holding in *Hochfelder*, can be squared with the lower "objective" standard applied by the Ninth Circuit and other lower courts. As this Court held in *Hochfelder*, the language and legislative history of Section 10(b) make clear that Congress intended to limit liability to those instances "where the defendant *has not acted in good faith.*" *Id.* at 206 (emphasis added). Under the objective standard, however, the defendants' good or bad faith is irrelevant. The reason is that an objective standard is premised upon negligence principles, not the law of deceit: an objective standard is concerned with the reasonableness of conduct, not with dishonesty.

The district court adhered closely to *Hochfelder*. Its analysis repeatedly turned on the absence of evidence showing petitioners' "bad faith." The Ninth Circuit, in applying an objective standard, reversed. Its analysis turned on the testimony of accounting experts about the standard of care, a standard indistinguishable from negligence. As the Court noted in *Hochfelder*, a negligence standard invariably leads to different results in Section 10(b) cases.

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following its "[a]dherence to the text in defining the conduct covered by § 10(b)").

A. The Language of the Statute is Not Consistent with the Imposition of Liability Under Section 10(b) for Mere Recklessness.

Prior to *Hochfelder*, several lower courts, including the Ninth Circuit in *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974), had held that negligence was a sufficient basis for Section 10(b) liability. *Hochfelder*, 425 U.S. at 193-94 n.12. Other decisions had rejected such an expansive interpretation of Section 10(b). The Court in *Hochfelder* rejected a negligence standard. *Id.*[12]

Noting that "[t]he 1934 Act was intended principally to protect investors against manipulation of stock prices," *id.* at 195, the *Hochfelder* Court began its analysis by examining the language of Section 10(b). The Court found that the statute's use "of the words 'manipulative,' 'device,' and 'contrivance' . . . make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence." *Id.* at 199. The Court read this language as plainly "connot[ing] intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Id.* The Court believed that the language of Section 10(b) "so clearly connotes intentional misconduct" that "further inquiry may be unnecessary." *Id.* at 201.[13]

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[12] The Court cited two opinions that cautioned against an unduly broad interpretation of Section 10(b). 425 U.S. at 194 n.12, 197, 213 n.32, 214. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J.) (liability under Section 10(b) should at least be limited to "the kind of recklessness that is equivalent to wilful fraud."); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 288 (3d Cir. 1972) (Adams, J., concurring and dissenting) (noting Judge Friendly's concern, 458 F.2d at 285 & n.41, and agreeing that "fraud or culpability appears to be the linchpin of Section 10(b) and the regulation thereunder.").

[13] The Court determined that the legislative history supported the interpretation that Section 10(b) was designed to

Based on Section 10(b)'s language and legislative history, therefore, the Court concluded that liability requires "a mental state embracing intent to deceive, manipulate, or defraud." In a footnote, the Court reserved the question whether "under some circumstances" recklessness might satisfy this standard. In doing so, the Court noted that, under the common law, recklessness sometimes is "considered to be a form of intentional conduct." *Id.* at 194 n.12. The Court concluded that it did not need to address whether such reckless behavior could satisfy the potentially higher standard set by the statutory language of Section 10(b).

Although lower courts have concluded that recklessness is sufficient under Section 10(b), that conclusion cannot be squared with the statutory language that the Court found compelling. The statute's use of the word "manipulative," which the Court found to be "especially significant," was "virtually a term of art when used in connection with securities markets." *Id.* at 199. In the securities context, the Court explained, the term has meant "[t]o force (prices) up or down, as by matched orders, wash sales, fictitious reports; to rig." *Id.* at 199 n.21. This interpretation, which emphasizes a deliberate scheme to defraud, not to mention the statute's use of the terms "device" and "contrivance," cannot be squared with merely reckless conduct. To the same effect is "the

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reach intentional misconduct. *See* 425 U.S. at 202 ("most relevant exposition of the provision," was the statement by a drafter of Section 10(b), who described it as "say[ing], 'Thou shalt not devise any other cunning devices.' "); *id.* at 202, 204-05 (Section 10(b) was "aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function," and intended to provide relief for investors who "suffered loss by reason of illicit practices."); *id.* at 206 (the terms "cunning," "manipulative," and "illicit," plainly gave "no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith.").

most relevant exposition" of the statute in the legislative history, which summarized Section 10(b) as "[t]hou shalt not devise any other cunning devices." *Id.* at 202. One cannot "devise cunning devices" simply by acting recklessly.

In holding that recklessness suffices as a basis for Section 10(b) liability, the courts of appeals have not attempted to fit their concept of recklessness with the statutory language. Rather, they have drawn analogies between Section 10(b) and common law tort claims, and cited to the broad remedial purposes of the statute.[14] As this Court emphasized in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), however, "*the statutory text controls the definition of conduct covered*" by Section 10(b), not analogies to the common law which find no support in the language of the statute. *Id.* at 175 (emphasis added). Nor do "generalized references to the 'remedial purposes' of the 1934 Act . . . justify reading a provision more broadly than its language and the statutory scheme reasonably permit." *Touche Ross & Co. v.*

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[14] *E.g., Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44, 45 (2d Cir.) ("no hint in *Hochfelder* that the Court intended a radical departure from [the] common law analogue of fraud") (citations and quotations omitted), *cert. denied*, 439 U.S. 1039 (1978); *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979) ("the purpose of footnote 12 of the *Hochfelder* opinion was to preserve, at least in the context of accountants' liability, the standards of scienter developed in [common law fraud cases]"); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979) (§ 10(b) "is to be liberally construed in order to effectuate the policies underlying the federal securities laws"); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir. 1977) ("highly inappropriate to construe the Rule 10b-5 remedy to be more restrictive in substantive scope than its common law analogs"); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982) (adopting recklessness "for the same reasons given by the other circuits . . . because the Securities Acts are to be broadly construed to achieve their remedial goals").

Redington, 442 U.S. 560, 578 (1979) (quotations and citations omitted). In *Central Bank*, the Court definitively stated: "[p]olicy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it." 511 U.S. at 188.

Recklessness – especially objective recklessness, which approaches mere negligence – does not satisfy the plain language of Section 10(b). It is completely inconsistent with the statute's legislative history. The question reserved in *Hochfelder* should be answered "No."

B. Even If Recklessness Were Sufficient Under Section 10(b), Only "Subjective Recklessness" – Bad Faith – Should Be Actionable.

Even if recklessness might "under some circumstances" provide a basis for Section 10(b) liability, *Hochfelder* plainly did not intend to create an exception to its holding requiring "a mental state embracing intent." 425 U.S. at 194 n.12. Rather, the Court recognized that the common law under certain circumstances had found that recklessness could be "a form of intentional conduct." *Id.*

The leading case in deceit law, *Derry v. Peek*, 14 App. Cas. 337 (U.K. 1889), established that "the necessary fraud required to sustain the action for deceit was actual fraud, *i.e.*, a *conscious misrepresentation*." Fowler V. Harper & Fleming James, Jr., *The Law of Torts* § 7.3, at 533 (1956) (emphasis added). At the same time, these deceit cases recognized that a person may make a conscious misrepresentation by asserting a fact to be true, for the purpose of inducing reliance, where "he knows that he does not know whether [the fact] is true or false – in other words, *with subjective recklessness*." *Id.* at 534 (emphasis added). As one treatise summarized the boundaries of liability for deceit under the common law:

> Deceit, as an intended wrong, should be confined to situations in which the defendant (a) *knew that his statements were untrue*, or (b) *knew that he did not know* whether they were true or false, and thus made the statements in reckless disregard of their truth or falsity. In each situation, there is no "honest" belief in the truth.

Id. at 537 (emphasis added). Common law deceit, "in short, makes honest belief in the truth a complete defense, under all circumstances." *Id.* at 534.

Nothing in *Hochfelder* provides the least support for going beyond subjective recklessness in imposing liability under Section 10(b). As this case demonstrates, liability is now being imposed in the Ninth Circuit without any regard to a defendant's *actual* mental state. Indeed, the principles applied by the Ninth Circuit below were recognized in the common law as drawn from the law of negligence – precisely the theory of liability unequivocally rejected in *Hochfelder*.

1. There Is A Split Among The Circuits And The Lower Courts Are in Complete Disarray as to Whether to Apply a Subjective or Objective Recklessness Standard.

In *Central Bank*, the Court emphasized the importance of clear and predictable rules regarding what conduct may be subject to liability under Section 10(b). Noting that Section 10(b) litigation "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general," the Court observed with respect to the question of aiding and abetting liability under Section 10(b):

> [T]he rules for determining . . . liability are unclear, in an area that demands certainty and predictability. That leads to the undesirable result of decisions made on an ad hoc basis, offering little predictive value to those who provide services to participants in the securities

> business. Such a shifting and highly fact-oriented disposition of the issue of who may be liable for a damages claim for violation of Rule 10b-5 is not a satisfactory basis for a rule of liability imposed on the conduct of business transactions.

511 U.S. at 188-89 (citations and quotations omitted).

Notwithstanding its undesirable consequences, "ad hoc" and "unpredictable" are the hallmarks of lower court decisions regarding the mental state required for Section 10(b) liability.[15] Since *Hochfelder*, commentators have uniformly criticized the chaos among the lower courts. As one commentator has observed, the case law since *Hochfelder* is "ad hoc," if "not largely incoherent," and courts have "done precious little to clarify the ambiguities," leading to the undesirable result that "actual and potential parties to Section 10(b) and Rule 10b-5 actions cannot predict with any degree of certainty how a trier of fact will characterize challenged conduct and thus whether it may serve as the basis for liability."[16]

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[15] *See In re Leslie Fay Cos., Inc. Sec. Litig.*, 835 F. Supp. 167, 172 & n.1 (S.D.N.Y.) (the scienter standard "is indeed a murky area of law in this circuit," and "[t]he confusion over what must be pled and what must be proven to show scienter in a 10b-5 case is so severe that it has resulted in conflicting opinions in the same case").

[16] Johnson, *supra*, at 674-75, 686. *Accord*, Paul S. Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. Corp. L. 179, 180 (1986) ("little uniformity . . . among the circuits or even among different panels of the same circuit, on how proof of recklessness should be used to satisfy scienter"; issue "has served as a veritable quagmire for the courts"); Marc I. Steinberg & Samuel H. Gruenbaum, *Variations of "Recklessness" After Hochfelder and Aaron*, 8 Sec. Reg. L. J. 179, 181, 183 (1980) (courts of appeals "have split deeply" on the meaning of recklessness, causing a "deep substantive impact" on the

The central problem is the disagreement as to whether Section 10(b) liability turns on what the defendant's mental state actually was, or on what an objective court (or expert) believes it should have been. Some lower court decisions have held that *Hochfelder* cannot properly be extended beyond the subjective recklessness found actionable in common law deceit. For example, in *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979), the Third Circuit held that under *Hochfelder*, the core "issue is *whether the defendants had an honest belief* that the statements made by them were true." If the defendants "did have that *honest belief*, whether reasonably or unreasonably, they are not liable." *Id.* at 1198 (quotations and citations omitted) (emphasis added). The central inquiry, as in deceit law, is the defendant's actual state of mind: a defendant can be held liable only if the plaintiff can "establish that the defendant lacked a genuine belief that the information disclosed was accurate and complete in all material respects." *Id.*

In *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977), the Seventh Circuit held that subjective recklessness is necessary for Section 10(b) liability:

> [R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is *so obvious that the actor must have been aware of it.*

Id. at 1045 (emphasis added). The Seventh Circuit explained that its definition requires "something more

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outcome of cases). *See also* Thomas Lee Hazen, *The Law of Securities Regulation* 460 (1985) (*Hochfelder*'s recklessness standard "seems to defy a more specific definition"; "the availability of a recklessness standard, as well as a more explicit definition, must await Supreme Court determination").

egregious than even 'white heart/empty head' good faith." *Id.* As the court explained, if "a defendant genuinely forgot to disclose information or . . . it never came to his mind," that would defeat a finding of recklessness, "even though the proverbial 'reasonable man' would never have forgotten." *Id.* at 1045 n.20.

Like the Third and Seventh Circuits, the Second Circuit has staked out a subjective recklessness standard. Under the Second Circuit's standard, a plaintiff must establish either defendants' "conscious misbehavior" or knowingly reckless conduct. In *Shields v. Citytrust Bancorp, Inc.*, the Second Circuit rejected a complaint that "strongly suggests that the defendants should have been more alert and more skeptical," because "nothing alleged indicates that management was promoting a fraud." 25 F.3d 1124, 1129 (2d Cir. 1994).

Other courts of appeals have explicitly adopted an objective standard. For example, in *Mansbach v. Prescott, Ball & Turben*, the Sixth Circuit concluded that "*Hochfelder* should be read to go no further than its specific holding that *mere* negligence is not enough for liability" 598 F.2d 1017, 1025 (6th Cir. 1979) (emphasis added). The Sixth Circuit found that there was "little analytical value" in defining where recklessness falls along the spectrum between negligence and specific intent, *id.* at 1025 n.36, concluding that it was enough to say that recklessness is "highly unreasonable conduct which is an extreme departure from the standards of ordinary care. While the danger need not be known, it must at least be so obvious that any reasonable man would have known of it." *Id.* at 1025.

The Ninth Circuit adopted an objective test in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc). Although it noted that something more egregious than "white heart/empty head" good faith should be required, as *Sundstrand* held, 914 F.2d at 1570, the Ninth Circuit did not adopt the Seventh Circuit's subjective standard. Although proposed by the SEC, the Ninth Circuit *rejected* a subjective standard. 914 F.2d at

1569 n.7. Indeed, the Ninth Circuit framed the scienter inquiry so as to ignore a defendant's actual mental state: "[T]he essential inquiry becomes: Was Titan's failure to disclose Wilkowski's eleven-year old forgery conviction highly unreasonable and did it constitute an extreme departure from standards of ordinary care?" 914 F.2d at 1570. Thus, the only question relevant to the Ninth Circuit is whether a defendant's conduct is highly unreasonable compared to the proverbial objective person in the same circumstances – in this case, plaintiffs' after-the-fact accounting experts.

2. The "Objective" Recklessness Standard Applied By The Ninth Circuit And Other Courts Effectively Imposes Section 10(b) Liability For Negligence.

Comparing the Ninth Circuit's objective standard to the standard applied in this Court's "actual malice" cases, which provide a useful analogy in applying common law scienter principles, demonstrates just how far the Ninth Circuit has wandered from *Hochfelder*'s requirement of "knowing or intentional misconduct." In defamation cases, the Court has held that liability may be imposed for a statement made "with knowledge that it was false or with reckless disregard of whether it was false or not." *New York Times Co. v. Sullivan*, 376 U.S. 254, 280 (1964). The Court has emphasized that the kind of "reckless disregard" that may be considered equivalent to knowingly false conduct is bad faith, or *subjective* recklessness. Bad faith is measured by the defendant's actual state of mind, not by experts' after-the-fact opinions as to the reasonableness of defendant's conduct. As the Court stated in *Harte-Hanks Communications, Inc. v. Connaughton*:

> A reckless disregard for the truth, however, requires more than a departure from reasonably prudent conduct. There must be sufficient evidence to permit the conclusion that the defendant in fact entertained serious doubts as to the

> truth of his publication. *The standard is a subjective one – there must be sufficient evidence to permit the conclusion that the defendant actually had a high degree of awareness of . . . probable falsity.*

491 U.S. 657, 688 (1989) (citations and quotations omitted) (emphasis added).

A defendant's state of mind cannot be determined by an objective test. Indeed, in *Harte-Hanks*, the Court expressly rejected a standard that "merely required a showing of 'highly unreasonable conduct constituting an extreme departure from the standards . . . ordinarily adhered to by responsible publishers.' " 491 U.S. at 664 (citation omitted). As the Sixth Circuit in *Mansbach* observed, the Court's defamation cases indicate the "equation of recklessness with subjective intent (scienter) in tort law." 598 F.2d at 1025. Referring to these defamation cases in *Hochfelder*, the Court held that "knowing or intentional misconduct" was required under Section 10(b). 425 U.S. at 197. The Court reserved only the question whether "recklessness [that] is considered to be a *form of intentional conduct*" might also be enough. *Id.* at 194 n.12 (emphasis added).

The objective standard adopted by the Ninth Circuit in *Hollinger* and applied here is far lower than what the Court has held was required under the common law to show "a form of intentional conduct." In this and other Section 10(b) cases, liability is being imposed on a lower basis that cannot meaningfully be distinguished from negligence.

II. Under Section 10(b) of the Securities Exchange Act of 1934, a Mere Difference of Accounting Opinion Cannot Create a Triable Issue of Scienter Where GAAP Permitted A Wide Range of Accounting Practices.

With respect to plaintiffs' core allegation of accounting fraud, Judge Pregerson's decision for the Ninth Circuit changes the summary judgment landscape. It

effectively returns to the pre-1986 standard used to evaluate summary judgment motions, when a mere "scintilla" could defeat summary judgment. Because forecasting and accounting issues form the bedrock for most securities cases, the Ninth Circuit's decision, if left undisturbed, could have sweeping consequences. It will add greatly to the uncertainty among district courts attempting to divine a consistent summary judgment standard.

At the core of this case is a fundamental question, namely, where GAAP permitted a range of acceptable accounting alternatives, what evidence is required to support an inference that the company's choice of alternatives amounts to "fraud?" The Ninth Circuit's answer is, "very little." It found a triable issue despite the following:

- MIPS' accounting practices were within industry norms in an evolving area of accounting;
- In every quarter at issue, MIPS voluntarily consulted with its auditors, Ernst & Young, who are not accused of fraud, to confirm that revenue was properly recognized, and Ernst & Young contemporaneously approved MIPS' accounting;
- MIPS' financial statements passed external audits in 1990 and 1991, and MIPS never restated any fiscal period; and
- Virtually all of MIPS' recorded revenue was collected.

(A11, A27; A81-85).

The Ninth Circuit's approach to summary judgment contradicts *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587, 596-97 (1986), where this Court directed lower courts to examine *"the record taken as a whole"* and to draw only "plausible" and "permissible" inferences from circumstantial evidence. This Court instructed that conduct "equally consistent with lawful action" as with fraudulent conduct "does not, without

more, support even an inference of conspiracy." *Id.* at 597 n.21. By reversing summary judgment on this record, the Ninth Circuit has effectively eliminated the vitality of summary judgment in accounting fraud cases.[17]

Rather than consider the evidence as a whole, as did the district court, the Ninth Circuit accepted snippets of evidence offered by plaintiffs' experts. It found a triable issue based almost entirely on the testimony of plaintiffs' accounting experts that they disagreed with the revenue recognition approach taken by MIPS and its auditors. The Ninth Circuit found that the experts' testimony created a triable issue even though the unrebutted record showed that no authoritative GAAP literature governed the emerging area of technology licensing or provided support for their conclusionary opinions.

Based on plaintiffs' experts' own literature there was *no* evidence that MIPS' revenue recognition practice was even incorrect, much less evidence that petitioners acted fraudulently. Indeed, if mere violations of GAAP are insufficient to support scienter, accounting within the range of GAAP cannot raise such an inference. Nevertheless, the Ninth Circuit held that plaintiffs' experts' debate with MIPS and its auditors over which was the better rule within the range of industry practice raises a triable issue of scienter. The Ninth Circuit's decision conflicts with the

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[17] The Ninth Circuit's conclusion that there was a triable issue of scienter as to MIPS' second quarter forecast also conflicts with *Matsushita*. It relied on the mere existence of a superseded internal spreadsheet, and a snippet of one witness' testimony. It reached this result even though it did not dispute the district court's finding, based upon the unrebutted testimony of *every* witness, that: "[t]he spreadsheet was the starting point for the discussion at the April 22-23 quarterly business review, not the quarterly forecast," and that "[t]here is no evidence that the spreadsheet was other than a *preliminary* worksheet and, as such, was not something that should have been disclosed to the public." (A20-21).

Court's holding in *Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993). There, the Court affirmed judgment *n.o.v.*, instructing that "[w]hen an expert opinion is not supported by sufficient facts to validate it in the eyes of the law, or when indisputable record facts contradict or otherwise render the opinion unreasonable, it cannot support a jury's verdict." *Id.* at 242. That rationale applies equally at summary judgment. The Ninth Circuit erred by not following it.

The Ninth Circuit's holding is squarely at odds with many decisions emphasizing that accounting is inherently judgment-laden and "tolerates a range of 'reasonable' treatments[.]" *Thor Power Tool* 439 U.S. 522, 544 (1979).[18] The Ninth Circuit ignored that plaintiffs' experts could not identify an authoritative accounting principle that MIPS violated. Its simple assertion that "revenue must be *earned* before it can be recognized" (A11) begs the fundamental question: when is revenue earned under GAAP?

The Ninth Circuit accepted the blanket conclusion of plaintiffs' experts that GAAP required deliverables to be transferred before revenue was "earned" without examining the literature upon which that opinion was based. (A11, A28). The court surprisingly disregarded evidence

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[18] *See In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1549 (9th Cir. 1994) (en banc) (accounting fraud requires more than "merely the difference between two permissible judgments."); *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426-27 (9th Cir. 1994) (experts' differences of accounting opinion "not sufficient" to create triable issue), *cert. denied*, 116 S. Ct. 277 (1995); *Malone v. Microdyne Corp.*, 26 F.3d 471, 479 (4th Cir. 1994) ("The mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter."); *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1240-41 (S.D.N.Y. 1992) ("The court heard diametrically opposing views from experts as to the reasonableness of [the] accounting and audit judgments. It follows that no finding of fraud or recklessness can rationally be made in this case.").

that reasonable accountants disagreed over when revenue under license agreements was "earned" even in the allegedly *analogous* software industry, and that GAAP embraced a range of practices. Indeed, many accountants believed revenue was earned immediately upon contract signing because "delivery is not a key event" and an "exchange occurs at contract signing, namely, the exchange of an obligation to deliver the software for a promise to be paid a licensing fee." (A97). MIPS' practice was consistent with this principle: MIPS always obtained a signed agreement by the end of the quarter, and the customer obtained a license and agreed to pay a "non-recoverable" license fee. (A82-85).[19]

Without citing a GAAP standard that was violated, plaintiffs' experts engaged in a tortured reading of MIPS' revenue recognition policy, which the Ninth Circuit accepted. According to plaintiffs' experts, MIPS' policy provided that " 'technology revenue is recognized upon the completion of contract requirements.' " (A11). The Ninth Circuit found that a triable issue existed based on MIPS' failure to transfer deliverables and to obtain government approval before recognizing revenue. The problem is that the iron-clad rule cited by plaintiffs' experts, and accepted by the Ninth Circuit, is inconsistent with the full text of MIPS' policy. Plaintiffs' experts omitted the word "Generally," which modifies the selectively-quoted portion of the policy. ER 172/139:F-6. They also omitted the entire preceding sentence, which made clear that revenue recognition was *"dependent upon the nature and level of efforts required to deliver and or support the technology transfer." Id.* (emphasis added). The Ninth Circuit accepted their selective reading. Thus, unlike the

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[19] MIPS did *more* than GAAP required by transferring significant deliverables to customers before recognizing revenue. (A83). The Ninth Circuit's skepticism that customers "had received nothing they could use" (A11) has no basis in the record.

district court, the Ninth Circuit never considered the miniscule effort required to transfer the deliverables, and the absence of any customer complaints. Nor did the Ninth Circuit mention that petitioners believed that any contingencies were immaterial.

The Ninth Circuit's deviation from the summary judgment standards articulated by this Court is not only of substantial concern to petitioners, but also to the numerous companies that must defend securities class action lawsuits, particularly those involving accounting allegations. In almost every case, plaintiffs will find experts willing to testify that they would have made different accounting decisions than those made by a company and its auditors. If this is sufficient to raise a triable issue where plaintiffs have not identified a GAAP standard that was violated, and virtually all of the challenged revenue was collected, it will be sufficient in every case, and summary judgment will be rendered a nullity.

CONCLUSION

For all of these reasons, certiorari should be granted.

Respectfully submitted,

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May 5, 1997

APPENDIX A

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

DIANE PROVENZ; AHIKIM EIZENBERG, *Plaintiffs-Appellants,* v. ROBERT C. MILLER; CHARLES M. BOESNBERG; DAVID G. LUDVIGSON; STEPHEN R. BENNION; WILLIAM D. JOBE; MIPS COMPUTER SYSTEMS, INC., *Defendants-Appellees.*	Nos. 95-15839, 95-16819 D.C. No. CV-92-20159-RMW AMENDED OPINION

Appeal from the United States District Court
for the Northern District of California
Ronald M. Whyte, District Judge, Presiding

Argued and Submitted
June 11, 1996 – San Francisco, California
Original Opinion Filed September 11, 1996

Amended Filed December 18, 1996

Before: Alfred T. Goodwin, Harry Pregerson, and
Alex Kozinski, Circuit Judges

Opinion by Judge Pregerson

SUMMARY

Securities/Fraud

The court of appeals affirmed a judgment of the district court in part and reversed in part. The court held

the sale of large volumes of stock by a corporation's principals following improper recognition of corporate revenue is sufficient to support a finding of scienter in a securities fraud action.

Appellants Diane Provenz and Ahikim Eizenberg brought a securities fraud class action against appellee MIPS Computer Systems, Inc. and its officers and directors, Charles Boesenberg, Robert Miller, David Ludvigson, Stephen Bennion, and William Jobe. The complaint alleged that during the class period, the value of MIPS' stock was artificially inflated because the defendants recognized revenue before it was earned and failed to disclose to the market information about the company's products and forecasts. The case was based on a fraud-on-the market theory.

The plaintiffs contended that in the fourth quarter of 1990 and the first quarter and second quarters of 1991, MIPS recognized nearly $15.5 million in revenue from certain transactions, although the revenue had not yet been earned. The complaint also charged that MIPS' failure to record a restructuring charge of $25.5 million before June 30, 1991 violated Generally Accepted Accounting Principals (GAAP). The plaintiffs also asserted that the MIPS forecasts for the second and third quarters of 1991 were false or misleading.

The plaintiffs moved to strike "new" evidence contained in the defendants' reply brief, and filed a supplemental declaration rebutting it. The district court denied the motion to strike the "new" evidence and also refused to consider the plaintiffs' supplemental declaration.

The court granted the defendants' motion for summary judgment, concluding that there was insufficient evidence of scienter to hold the defendants liable for securities fraud. The court awarded the defendants their costs. Provenz and Eizenberg appealed.

[1] The district court erred in not considering the plaintiffs' supplemental declaration.

[2] MIPS's own policy, which was in existence during the class period, stated that "technology revenue is recognized upon the completion of contract requirements." [3] Intellectual property was involved, and purchase orders contained various contingencies. [4] The plaintiffs raised genuine issues of material fact as to whether technology transfers in fact occurred during the sales process, and whether such transfers were sufficient under GAAP to support the recognition of revenue. Looking at the evidence in the light most favorable to the plaintiffs, it appeared that in certain transactions, the defendants recognized revenue before binding agreements existed and before contract requirements were completed.

[5] Nothing suggested that the accounting decision to wait to record the restructuring charge until the third quarter violated GAAP or any of MIPS' policies. The defendants' decision to record the restructuring in the third quarter rather than the second quarter was not actionable as a false or misleading statement.

[6] The plaintiffs' claim, that certain statements made during a conference call were false and misleading, was based on a MIPS internal spread sheet. [7] Ludvigson predicted a profit when MIPS had information that the

company would suffer a loss. There was no evidence in the record that the defendants disclosed to analysts the financial information upon which the internal forecast was based. The plaintiffs raised a genuine issue of material fact as to whether the defendants' projections for the second quarter made during the conference call were false or misleading. A jury could reasonably have found that the defendants' representation that a loss would be "small" without a restructuring charge was false or misleading, given that the defendants were projecting a $3 million loss without the restructuring charge.

[8] Based on the evidence, a jury could reasonably have found that the defendants' allegedly false and misleading statements were material and affected the total mix of information upon which a reasonable investor would have relied.

[9] The plaintiffs did not have any direct evidence that the defendants acted with scienter. Rather, the plaintiffs contended that the defendants' allegedly false and misleading statements, combined with evidence of insider trading, were sufficient to raise a reasonable inference of scienter. [10] The defendants appeared to have violated MIPS' own policies when recognizing revenue for certain transactions. [11] The district court was wrong in resolving factual disputes that existed as to underlying transactions. The plaintiffs provided documentary evidence suggesting that the defendants may have recognized revenue before it was earned, and expert testimony in support of their contentions. That evidence was sufficient to overcome summary judgment. [12] There was also evidence suggesting that the defendants failed to disclose material information to their accountant.

[13] According to the plaintiffs, the individual defendants and other corporate insiders sold over $8.8 million worth of their individual holdings during the class period. The district court incorrectly concluded that the sales of stock by Miller and Boesenberg did not support a finding of scienter. There was evidence that Miller and Boesenberg traded their stock in large amounts at sensitive times. [14] However, the district court was correct in granting summary judgment in favor of Bennion and Jobe. Bennion and Jobe provided unrebutted evidence that they sold their stock for innocent reasons. [15] Even though Ludvigson's stock sales were too minimal to suggest insider trading, a genuine issue of material fact existed as to whether Ludvigson acted with scienter. Ludvigson made many of the allegedly false and misleading statements to the analysts during conference calls, and was personally involved in and approved each decision to record revenue for licensing agreements entered into during the class period.

[16] Given the record, the district court was correct in refusing to grant summary judgment on a "loss causation" defense.

[17] Although the defendants claimed that information about the risky nature of MIPS' stock entered the market, [18] it could not be said as a matter of law that the defendants established the "truth-on-the-market" defense. [19] In addition, alleged cautionary statements appeared to be too general to trigger the "bespeaks caution" doctrine.

[20] The plaintiffs' appeal from the district court's order awarding costs was moot.

COUNSEL

Jonathan K. Levine, Kaplan, Kilsheimer & Fox, New York, New York and Patrick J. Coughlin, Milberg, Weiss, Bershad, Hynes & Lerach, San Diego, California, attorneys for the plaintiffs-appellants.

Steven M. Schatz, Wilson, Sonsini, Goodrich & Rosati, Palo Alto, California, attorneys for the defendants-appellees.

OPINION

PREGERSON, Circuit Judge:

Plaintiffs Diane Provenz and Ahikim Eizenberg, on behalf of themselves and all other similarly situated purchasers of stock of MIPS Computer Systems, Inc. (MIPS), appeal the district court's grant of summary judgment in favor of all defendants. Plaintiffs brought this action against MIPS and MIPS' officers and directors, Charles M. Boesenberg, Robert C. Miller, David G. Ludvigson, Stephen R. Bennion, and William D. Jobe, under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. § 240.10b-5. The plaintiffs also appeal the district court's order awarding costs to defendants. The district court had jurisdiction under 28 U.S.C. § 1331. We have jurisdiction under 28 U.S.C. § 1291. We affirm in part, reverse in part, and remand.

BACKGROUND

The plaintiffs brought this securities fraud case as a class action. The class period runs from January 31, 1991, through October 9, 1991. Plaintiffs allege that, during the class period, the value of MIPS' stock was artificially inflated because defendants recognized revenue before the revenue was earned and failed to disclose to the market information about MIPS' products and forecasts. At the beginning of the class period, MIPS' stock traded at about $11 a share. At the high end of the class period, MIPS' stock traded at $20 5/8 a share. On October 10, 1991, the day that plaintiffs allege the fraudulently withheld information about MIPS' business and prospects entered the market, the price of the MIPS' stock declined to about $9 a share.

On June 27, 1994, the district court granted defendants' motion for summary judgment. The district court held that there was insufficient evidence of scienter to hold defendants liable for securities fraud. The district court also awarded defendants their costs. This appeal followed.

STANDARD OF REVIEW

A grant of summary judgment is reviewed de novo. *Warren v. City of Carlsbad*, 58 F.3d 439, 441 (9th Cir. 1995), *cert. denied*, 116 S.Ct. 1261 (1996). A court must view the evidence in the light most favorable to the non-moving party and draw any reasonable inferences in the non-moving party's favor. *Id.* Summary judgment is proper only if no genuine issue of material fact exists and only if the moving party is entitled to judgment as a matter of

law. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986). Where material factual disputes exist, the court must allow a jury to resolve the factual disputes. *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1161 (9th Cir. 1992).

ANALYSIS

I. Procedural Issues

As a preliminary matter, we must resolve two procedural issues. First, after defendants filed their reply brief but before the hearing, plaintiffs filed a motion to strike the "new" evidence contained in defendants' reply. The plaintiffs also filed a supplemental declaration that rebutted defendants' "new" evidence. The district court denied plaintiffs' motion to strike the defendants' "new" evidence and also refused to consider plaintiffs' supplemental declaration.

[1] We believe the district court erred in not considering plaintiffs' supplemental declaration. In *Marshall v. Gates*, 44 F.3d 722, 723-25 (9th Cir. 1995), we noted that Fed. R. Civ. P. 56(c) states, in relevant part, that a "party prior to the day of hearing may serve opposing affidavits." Although we interpreted this language as allowing a district court to adopt local rules that set time limits for a non-moving party to follow in opposing a motion for summary judgment, our holding in *Marshall* does not mean that defendants in this case may submit "new" evidence in their reply without affording plaintiffs an opportunity to respond. Such a result would be unfair.

We agree with the Seventh Circuit, which held that "[w]here new evidence is presented in a reply to a motion

for summary judgment, the district court should not consider the new evidence without giving the [non-]movant an opportunity to respond." *Black v. TIC INV. Corp.*, 900 F.2d 112, 116 (7th Cir. 1990). Thus, in resolving this appeal, we have considered both the evidence submitted by defendants in their reply and the evidence submitted by plaintiffs in their supplemental declaration.

As to the second procedural issue we must resolve, plaintiffs contend that the district court abused its discretion in denying plaintiffs' motion for reconsideration that was based on allegedly newly discovered evidence. In their motion, plaintiffs submitted a declaration of a MIPS ex-employee. It appears, however, that plaintiffs learned about this employee well before plaintiffs filed their opposition. In these circumstances, we cannot say that the district court abused its discretion in denying plaintiffs' motion for reconsideration.

II. The Merits

To prevail on their securities fraud claims under section 10(b) and Rule 10b-5, plaintiffs must prove: (1) that defendants made a false statement or failed to disclose information that rendered another statement misleading; (2) that such statement or omission was material; (3) that plaintiffs relied on the statement or omission; and (4) that defendants acted with scienter or an intent to defraud. *Monroe v. Hughes*, 31 F.3d 772, 776 (9th Cir. 1994); *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1113 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990).

A. The Alleged False and Misleading Statements

In a securities fraud case, summary judgment is improper if a plaintiff "shows a genuine issue of fact with regard to a particular statement by the company or its insiders." *In re Worlds of Wonder Securities Litigation* ("*WOW*"), 35 F.3d 1407, 1412 (9th Cir. 1994) (quotations and citations omitted), *cert. denied*, 116 S.Ct. 185 (1995) and 116 S.Ct. 277 (1995). As we have explained, "[l]iability depend[s] on the plaintiffs' success in demonstrating that one of the statements made by the company was actually false or misleading." *In Re Convergent Technologies Securities Litigation*, 948 F.2d 507, 512 (9th Cir. 1991). Thus, to determine whether summary judgment was proper in this case, we must examine each false or misleading statement allegedly made by defendants.

1. Defendant's Income Recognition Practices

Plaintiffs allege that during the class period in question defendants made false statements in MIPS' quarterly income statements when they recognized revenue before it was earned. According to plaintiffs, under Generally Accepted Accounting Principles (GAAP) and MIPS' own policies, defendants could not recognize income until a binding agreement existed, until deliverables[1] were shipped, and until material contingencies were satisfied. When revenue can be recognized is what is at issue in this case.

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[1] "Deliverables" include the computer tape containing programs and databases as well as the documents and manuals describing the technology.

[2] Although defendants maintain that during the class period at issue no specific GAAP rules existed governing revenue recognition for technology licensing agreements, defendants do not appear to dispute plaintiffs' contentions that, under GAAP, revenue must be *earned* before it can be recognized. Defendants concede that, under GAAP, the earnings process must be substantially completed and an exchange must have occurred before revenue can be recognized. MIPS' own policy, which was in existence during the class period, states that "technology revenue is recognized upon the completion of contract requirements."

[3] That contract requirements had to be completed before revenue could be recognized as "earned" makes perfect sense given the way that MIPS and its customers structured their deals and given the fact that intellectual property was involved. The purchase orders that were signed by customers contained various contingencies, including the approval of foreign governments and the receipt of deliverables. In some instances, the terms of the licensing agreements had not yet been negotiated or finalized when customers signed the purchase orders. Although the signed purchase orders stated that the licensing fee was nonrecoverable, normally no money exchanged hands until after customers received the deliverables. As a result, MIPS had a policy of not shipping any deliverables until a binding agreement existed. Finally, the technology that customers purchased was not completed or "taped out" until March 1991. Before that date, and until MIPS' customers received the actual technology, MIPS customers had received nothing they could use.

Defendants, however, contend, and the district court agreed, that the bulk of MIPS' technology was transferred during the sales process. As the district court explained:

> The manner by which MIPS recognized revenue *appears* to have *basically* been consistent with its own written policy on the subject and GAAP . . . . The evidence indicates that while in some instances partial deliverables remained unshipped after revenue was recognized, the bulk of the terms of the technology transfers (i.e. transfer of sufficient technology to allow the purchaser to begin RISC utilization, payment and acceptances of nonrecoverable fees, etc.) had been substantially satisfied.

(Emphasis added.)

[4] The evidence, however, is not so clear and tells a more complicated story. We have combed through the record and are unable to determine what exactly was transferred to customers during the sales process. The technology, although licensed, had not yet been completed. If any technology was transferred during the sales process, such transfers would have been inconsistent with MIPS' policy of not transferring any technology until a binding contract had been executed. Thus, we find that plaintiffs have raised genuine issues of material fact as to whether technology transfers in fact occurred during the sales process and whether such transfers were sufficient under GAAP to support the recognition of revenue. Further, looking at the evidence in the light most favorable to plaintiffs, it appears that, in the transactions described below, defendants recognized revenue before binding agreements existed and before contract requirements were completed.

a. The Fourth Quarter for 1990

Plaintiffs contend that, in the fourth quarter of 1990, defendants recognized nearly $3 million in revenue from transactions with Sony, NEC, Control Data, Convex, and Olivetti. According to plaintiffs, had defendants not recognized this revenue, MIPS would have reported a $2,576,000 loss rather than the $546,000 loss, that was actually reported.[2]

i. Sony

In the fourth quarter of 1990, defendants recognized $1 million in revenue from Sony based on a letter from Sony stating that it was exercising an option to purchase a license. The letter, however, stated that Sony was "agree[ing] to discuss, in good faith, the details and schedule associated with the above option during the first quarter of 1991." The discussions over the licensing agreement appear to have taken place after the income was recognized. An agreement was executed in April 1991 and provided that Sony's obligation to pay was conditioned on its receipt of all deliverables. In May 1991, Sony still had not received all deliverables.

ii. NEC

In the fourth quarter of 1990, defendants recorded $250,000 in revenue from NEC based on a signed

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[2] Defendants reported a total revenue of $43.1 million for the fourth quarter.

purchase order. That purchase order contained various contingencies, none of which had been satisfied when the revenue was recognized. In addition, plaintiffs provided evidence that suggests the actual agreement may have been finalized sometime in April 1991.

iii. Control Data

In the fourth quarter of 1990, defendants recognized $250,000 in revenue from Control Data. Plaintiffs provided evidence that suggests material terms of the licensing agreement were still being negotiated when defendants recognized the revenue.

iv. Olivetti

In the fourth quarter of 1990, defendants recognized $950,000 in revenue from Olivetti. According to defendants, a binding agreement in the form of a signed letter of intent existed when the revenue was recognized. However, plaintiffs have provided documentary evidence that suggests that a binding agreement may not have been executed until after the fourth quarter ended and that Olivetti may have signed a backdated agreement. It also appears that the deliverables were not shipped until February 19, 1991.

v. Convex

In the fourth quarter of 1990, defendants recognized $450,000 in revenue from Convex based upon a December

28, 1990 agreement, which gave Convex the right to cancel and receive a full refund if MIPS failed to tape out the R4000 by December 31, 1991. There is evidence in the record that suggests the R4000 microprocessor was behind schedule. In addition, the deliverables had not yet been shipped when the revenue was recognized.

b. The First Quarter of 1991

According to plaintiffs, in the first quarter of 1991, defendants recognized $8 million in revenue from NKK, NEC, and Wang, which had not yet been earned.[3] As a result, MIPS reported a $624,000 profit for the quarter. Had defendants not recognized the alleged unearned revenue, MIPS would have recorded a loss of more than $4.3 million.

i. NKK

In the first quarter of 1991, defendants recognized $5 million in revenue from NKK based upon an agreement which was subject to approval from the Japanese government. In addition, plaintiffs contend that this agreement was subject to another material contingency – set out in a "side letter" – which stated that MIPS was required to ship deliverables by December 31, 1991. Defendants recognized the revenue before the deliverables were shipped and before the Japanese government provided its approval of the agreement.

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[3] Apparently, for the first quarter of 1991, MIPS recognized about $43 million in total revenue.

ii. NEC

In the first quarter of 1991, defendants recognized $2.25 million in revenue from NEC based on a purchase order for the extension of an existing licensing agreement. The purchase order, however, indicated that NEC could not formally enter into an agreement at that time. Apparently, the parties may not have reached an agreement until June 26, 1991. The June 26, 1991 agreement provided that it was not effective until executed and the Japanese government's approval obtained.

c. The Second Quarter for 1991

According to plaintiffs, in the second quarter of 1991, defendants improperly recognized $4.5 million revenue from NEC, Daewoo, and Tandem.

i. NEC

In the second quarter of 1991, defendants recognized $2 million in revenue from NEC based upon a purchase order for a joint venture with NEC called the Advanced Computing Environment ("ACE") initiative. Plaintiffs, however, provided evidence that suggests that at the time the revenue was recognized, NEC and MIPS were just beginning to negotiate the terms of the licensing agreement. In fact, as will be discussed below, ACE had not yet been announced. Thus, there is a question as to whether ACE in fact existed when the revenue was recognized.

ii. Daewoo

In the second quarter of 1991, defendants recognized $2 million in revenue from Daewoo based on an "agreement" which required the Korean government's approval before it could be considered binding. Plaintiffs' evidence shows that when the income was recognized, the terms of the licensing agreement were still being negotiated, and the Korean government had not yet approved the agreement. In fact, the approval was not obtained until the third quarter of 1991, and only after the Korean government sought various changes to the licensing agreement.

iii. Tandem

In the second quarter of 1991, defendants recognized $600,000 in revenue from Tandem. Plaintiffs contend that a licensing agreement with Tandem was not binding when signed on June 30, 1991, because the agreement had not been finalized. Plaintiffs provided evidence that suggests drafts of the agreement were circulated as late as August and September 1991. An agreement was executed on October 1, 1991. In addition, it appears that Tandem did not execute a purchase order until November 6, 1991.

2. The Restructuring Reserve

Plaintiffs contend that MIPS' failure to record a restructuring charge of $25.5 million before June 30, 1991 violated GAAP. Plaintiffs' experts assert that defendants should have recorded the restructuring by the end of the second quarter of 1991, because at that time defendants

knew a restructuring was necessary. In April 1991, MIPS and twenty other companies announced the formation of ACE, the Advanced Computing Environment initiative.

MIPS, however, waited until the third quarter of 1991 to record the restructuring charge. Apparently, defendants waited until then because MIPS had not yet made a formal decision to redirect its new product development around ACE. MIPS made this decision at the end of the second quarter of 1991. At that time, MIPS warned that a restructuring in the third quarter would be "significant" and would cause "a loss position for the third quarter and for total year 1991."

[5] We fail to see why waiting to record the restructuring charge until the third quarter was unreasonable. In reviewing the whole record, we find nothing that suggests this accounting decision violated GAAP or any of MIPS' policies. Thus, we hold that the defendants' decision to record the restructuring in the third quarter rather than the second quarter is not actionable as a false or misleading statement.

3. Defendants' Forecasts

Plaintiffs contend that defendants' forecasts for the second and third quarters of 1991 were false or misleading. The district court rejected plaintiffs' contentions. The district court explained:

> Plaintiffs . . . have pulled isolated statements out of context. The overall effect of defendants' statements was cautionary and could not be said to have misled the market. As one analyst wrote in June 1990, "MIPS has a complex business

> model that is still in the process of maturing. . . . This is not a stock for the fainthearted."

By this explanation, the district court is alluding to the "bespeaks caution" doctrine and the "truth-on-the-market" doctrine, both of which have been developed by the courts to immunize defendants from liability for false and misleading statements. *See WOW*, 35 F.3d at 1413-15 ("The bespeaks caution doctrine provides a mechanism by which a court can rule as a matter of law . . . that defendants' forward-looking representations contained enough cautionary language or risk disclosure to protect the defendant against claims of securities fraud.") (quoting Donald C. Langevoort, *Disclosures that "Bespeak Caution"*, 49 Bus.Law. 481, 482-83 (1994)); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir. 1989) ("Prompt incorporation of news into the stock price is the foundation for the fraud-on-the-market doctrine and therefore supports a truth-on-the-market doctrine as well.")

Before we consider these doctrines, we must first determine whether defendants' forecasts are actionable as false or misleading statements.

A projection is a "factual" misstatement "if (1) the statement is not actually believed, (2) there is no reasonable basis for the belief, *or* (3) the speaker is aware of undisclosed facts tending seriously to undermine the statement's accuracy." *Kaplan v. Rose*, 49 F.3d 1363, 1375 (9th Cir. 1994) (citing *In re Wells Fargo Securities Litigation*, 12 F.3d 922, 930 (9th Cir. 1993) (emphasis added), *cert. denied*, ___ U.S. ___, 115 S.Ct. 295 (1994)). In this case,

plaintiffs focus on various statements made during conference calls with analysts.

a. The 1991 Second Quarter Forecasts

In an April 25, 1991 conference call with market analysts, defendant Ludvigson, MIPS' chief financial officer ("CFO"), stated that MIPS expected technology revenues "to decline slightly from the Q1 levels" but expected "higher technology revenue performance . . . for the total year." Although Ludvigson cautioned that he "would be hesitant to put a total number on it," he suggested that MIPS' earnings for the second quarter would be similar to the $624,000 earnings reported for the first quarter. Specifically, Ludvigson stated that his "expectations for Q2 would be bottom line about Q1."

[6] Plaintiffs' claim that these statements were false and misleading is based on a MIPS' internal spread sheet which predicted a loss of 17 cents per share. The spread sheet was dated April 17, 1991, eight days before the conference call. The spread sheet showed that MIPS' internal forecasts projected a loss of $4,000,000 for the second quarter.

The district court, however, did not think that the internal spreadsheet raised a triable issue of material fact. As the district court explained:

> Plaintiffs ignore all of the other documents and testimony that put the spread sheet in context. The spreadsheet was the starting point for the discussion at the April 22-23 quarterly business review, not the quarterly forecast. The entire purpose of the quarterly business review was to

> develop a forecast for the quarter, known as the "QBR commitment." The QBR commitment is consistent with the general guidance given during the April 25 conference call, was distributed shortly thereafter, and was presented to the board on May 15, as a second quarter forecast. There is no evidence that the spreadsheet was other than a *preliminary* worksheet and, as such, was not something that should have been disclosed to the public. Nor does it suggest, given the way it was prepared, that defendants were hiding adverse facts.

The district court is partially correct. As we recently explained in *In re Stac Electronics Sec. Litig.*:

> Issuers need not reveal all projections. Any firm generates a range of estimates internally or through consultants. It may reveal the projection it thinks best while withholding the others, so long as the one revealed has a "reasonable basis" – a question on which other estimates may reflect without automatically depriving the published one of foundation.

89 F.3d 1399, 1411 (9th Cir. 1996) (quoting *In re VeriFone Sec. Litig.*, 784 F.Supp. 1471, 1487 (N.D. Cal. 1992), *aff'd*, 11 F.3d 865 (9th Cir. 1993).

[7] In this case, Ludvigson predicted a profit when in fact MIPS had information that the company would suffer a loss. We found no evidence in the record that the defendants disclosed to analysts the financial information upon which the internal forecast was based. Further, according to the deposition testimony of MIPS' employees, the internal forecast represented "the best,

most accurate representation as of the time it was prepared of what the company's financial results [would] be like for the prospective quarter." Based on this evidence, a reasonable trier of fact could conclude that defendants' forecasts or projections of a profit in the second quarter were unreasonable in light of the internal forecasts which indicated a loss for the second quarter. We find that plaintiffs have raised a genuine issue of material fact as to whether defendants' projections for the second quarter made during the April 25, 1991 conference call were false or misleading.

b. The 1991 Third Quarter Projections

In a July 30, 1991 press release, MIPS announced that it was going to take a "significant" restructuring charge in the third quarter. In a conference call with market analysts that same day, Ludvigson said that "the restructuring charge would be significant enough to put [MIPS] in a loss position for the third quarter and for total year 1991." Ludvigson, however, represented that, without the restructuring charge, the loss of revenue for the third quarter would be small.

Plaintiffs contend that these statements were misleading because defendants knew that there would be a huge loss without the restructuring charge. Plaintiffs point out that, only five days before the conference call, at the MIPS' Board of Directors meeting, defendants predicted a loss of more than $4.3 million without the restructuring charge.

The district court, however, rejected plaintiffs' evidence and found "that MIPS' forecasts were not inconsistent with the financial information they had concerning product and service revenue." At the July 30, 1991 teleconference, MIPS disclosed facts which suggested that it would suffer a multi-million dollar loss in the third quarter of 1991, independent of the restructuring charge. This forecast was consistent with the information that defendants had. We therefore conclude that the third quarter forecast is not actionable as a false or misleading statement.

4. Defendants' Omissions about the R6000 Line

Plaintiffs also allege that defendants failed to disclose that MIPS was having serious technical problems with its R6000 line. The district court, however, did not find defendants' failure to disclose this information to be misleading because the defendants had already disclosed that MIPS was having problems with its supplier. Defendants identified sourcing and cost problems with the R6000 line in their SEC Form 10-K and 10Q filings.

But a jury may find that such disclosures were not sufficient. As we have explained:

> There is a difference between knowing that any product-in-development may run into a few snags, and knowing that a particular product has already developed problems so significant as to require months of delay.

Convergent Technologies, 948 F.2d at 515, n.2 (citing *Apple Computer*, 886 F.2d at 1113-14).

Here, plaintiffs have provided evidence suggesting the R6000 line was experiencing more than simply supply problems. The R6000 line was plagued with delays and performance problems so severe that MIPS was losing orders and constantly cutting sales forecasts. Defendants, however, continued to represent to analysts that there was "pretty significant demand" and that shipment levels would increase in the third quarter of 1991. Based on this evidence, we believe that a jury could reasonably find that defendants' statements about the R6000 line were false or misleading.

B. Reliance

Plaintiffs contend that defendants' alleged false and misleading statements defrauded the market by causing the price of MIPS' stock to be overvalued during the class period in question. Thus, plaintiffs' case is based on a "fraud on the market" theory. This court has recognized that where a "fraud on the market" is alleged, plaintiffs are not required to "show that they themselves actually relied on any particular misrepresentation or omission." *Convergent Technologies*, 948 F.2d at 512, n.2 (citing *Apple Computer*, 886 F.2d at 1113-14). To show reliance, plaintiffs simply must "show that they relied on the integrity of the price of the stock as established by the market, which in turn is influenced by information or the lack of it." *Id.* Thus, in a "fraud on the market" case, "[a]n investor's reliance on the market . . . is equivalent to reliance upon statements made to the market, or the nondisclosure of material information." *Id.* Defendants do not dispute plaintiffs' allegations of reliance.

C. Materiality

In "a fraud on the market" case, a plaintiff must still establish that the false or misleading statements are material. Materiality is established by "showing that a reasonable shareholder would consider the misrepresentation or omission important, because it altered the total mix of available information." *Kaplan*, 49 F.3d at 1381 (quotations and citations omitted).

[8] Defendants do not appear to dispute that the alleged false and misleading statements were material. Nor do we think that defendants can establish that the alleged false and misleading statements were *not* material as a matter of law. As we recently stated: "Whether an omission is 'material' is a determination that 'requires delicate assessments of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact.' " *Fecht v. Price*, 70 F.3d 1078, 1080 (9th Cir. 1995) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976)). Thus, only if materiality is "so obvious that reasonable minds [could] not differ" is summary judgment appropriate. *Id.* at 1081 (quotations and citations omitted). Based on the evidence in this case, we believe that a jury could reasonably find that defendants' allegedly false and misleading statements were material and affected the total mix of information upon which a reasonable investor would have relied.

D. Scienter

Generally, scienter should *not* be resolved by summary judgment. As we have explained:

> Cases where intent is a primary issue generally are inappropriate for summary judgment unless *all* reasonable inferences that could be drawn from the evidence defeat the plaintiff's claim . . . . However, in opposing a motion for summary judgment the plaintiff must present significant probative evidence relevant to the issue of intent, e.g. the time, place or nature of the alleged fraudulent activities; mere conclusionary allegations are insufficient to require the motion for summary judgment be denied.

Vaughn, 628 F.2d at 1220 (emphasis added). Thus, summary judgment on the scienter issue is appropriate *only* where "there is no rational basis in the record for concluding that any of the challenged statements was made with requisite scienter." *In re Software Toolworks*, 38 F.3d 1078, 1088 (9th Cir. 1994) (quotations and citations omitted).

To establish scienter, plaintiffs must show that defendants had " 'a mental state embracing an intent to deceive, manipulate, or defraud.' " *WOW*, 35 F.3d at 1424 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976)). Plaintiffs can "establish scienter by proving either actual knowledge or recklessness." *Software Toolworks*, 38 F.3d at 1088. As we have explained, "reckless" conduct involves " 'not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or

is so obvious that the actor must have been aware of it.' " *Id.* (quoting *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991)).

[9] Scienter can be established by direct or circumstantial evidence. *See WOW*, 35 F.3d at 1425. Plaintiffs in this case do not have any direct evidence that defendants acted with scienter. Rather, plaintiffs contend that defendants' allegedly false and misleading statements, combined with the evidence of insider trading, is sufficient to raise a reasonable inference of scienter.

The district court, however, disagreed and held that summary judgment in favor of defendants was appropriate here because plaintiffs' evidence was insufficient to establish scienter. As the district court explained:

> If plaintiffs' papers are stripped of their harsh rhetoric they illustrate, at most, a difference of opinion as to when revenue should have been recognized. The facts do not justify a reasonable inference of fraudulent intent.

Further, according to the district court, defendants' good faith is evidenced by the fact that defendants allowed their accountant to audit MIPS' revenue recognition practices in January 1991 and January 1992. Both audits found that MIPS' accounting practices complied with GAAP. In addition, as the district court noted, MIPS regularly consulted with their accountant each quarter to confirm that transactions were completed or sufficiently completed to allow the recognition of revenue. Thus, the district court found that MIPS' reliance on outside auditors was inconsistent with an intent to defraud.

[10] At first glance, the district court appears to be correct. As we recently stated, " '[t]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter.' " *Software Toolworks*, 38 F.3d at 1089 (quoting *WOW*, 35 F.3d at 1426). But here defendants appear to have violated MIPS' own policies when recognizing revenue for certain transactions.

[11] In addition, we agree with plaintiffs that the district court was wrong in resolving the factual disputes which exist as to the underlying transactions. Not only have plaintiffs provided documentary evidence that suggests that defendants may have recognized revenue before it was earned, they also provided expert testimony in support of their contentions. This evidence is sufficient to overcome summary judgment.

"As a general rule, summary judgment is inappropriate where an expert's testimony supports the non-moving party's case." *WOW*, 35 F.3d at 1425 (citing *Apple Computer*, 886 F.2d at 1116). Here, plaintiffs' two experts have explained in great detail how defendants' recognition of revenue for various transactions violated GAAP and MIPS' own internal policy for recognizing revenue. *See In re GlenFed, Inc. Securities Litigation*, 42 F.3d 1541, 1549 (9th Cir. 1994) (stating that under Rule 9(b) a plaintiff must "explain[ ] why the difference . . . is not merely the difference between two permissible judgments").

Defendants, however, assert that our *WOW* decision compels an affirmance in this case. In *WOW*, the court held that plaintiffs' expert testimony was insufficient to raise a reasonable inference of scienter. 35 F.3d at 1425-26.

As the court explained, "[a]n expert's conclusory allegations that a defendant acted with scienter are insufficient to defeat summary judgment where the record clearly rebuts any inference of bad faith." *Id.* at 1426.

[12] But *WOW* is distinguishable. In *WOW*, defendants provided *unrebutted* evidence showing that their accountants had full knowledge of the disputed transactions. 35 F.3d at 1426. Here, there is evidence suggesting defendants failed to disclose material information to their accountant. If it is true that defendants withheld material information from their accountants, defendants will not be able to rely on their accountant's advice as proof of good faith. *See C.E. Carlson, Inc. v. SEC*, 859 F.2d 1429, 1436 (10th Cir. 1988) (stating that full disclosure to professional must be established to support the defense of reliance on expert opinion).

Plaintiffs also point to defendants' stock sales during the class period as evidence of defendants' bad faith. We have held that "[i]nsider trading in suspicious amounts or at suspicious times is probative of scienter." *Apple Computer*, 886 F.2d at 1117. We, however, also have recognized that "credible and wholly innocent explanations for stock sales, ranging from long-standing programs of periodic divestment, to the need to free cash to meet matured tax liabilities, [if] . . . *unrebutted* . . . are sufficient to defeat any inference of bad faith." *Id.* (emphasis added).

[13] According to plaintiffs, the individual defendants and other corporate insiders sold over $8.8 million of their individual holdings during the class period. The district court, however, found that "neither the time nor the amount of the sales support a finding of scienter and

are consistent with defendants' innocent explanations." We agree that this observation applies to some defendants but not as to other defendants.

The district court incorrectly concluded that the sales of stock by Miller and Boesenberg did not support a finding of scienter. There is evidence that Miller, MIPS' chairman and CEO, and Boesenberg, MIPS' president, traded their stock in large amounts at sensitive times. Miller sold about 20% of his stock for $1,340,000. Boesenberg sold about 90,000 shares during the class period – almost six times more stock than he had sold during the twelve months preceding the class period – for $1,479,650. Both Miller and Boesenberg sold their stock shortly after the April 25, 1991 conference call but before the $4 million loss and the restructuring charge were disclosed to the public.

[14] However, we believe the district court was correct in granting summary judgment in favor of defendants Bennion and Jobe. Bennion, MIPS' vice president and treasurer, and Jobe, MIPS' president of the technology group, provided unrebutted evidence that they sold their stock for innocent reasons. Apparently, Bennion sold some shares to purchase a new home and sold the remainder of his stock when he resigned. Jobe also sold his shares to buy a new home. Jobe sold more stock before the class period than during it.

[15] Whether defendant Ludvigson, MIPS' CFO, was entitled to summary judgment presents a more difficult question. Although Ludvigson sold only 3,265 shares during the class period, Ludvigson made many of the allegedly false and misleading statements to the analysts

during the April 25, 1991 and July 31, 1991 conference calls. In addition, Ludvigson was personally involved in and approved each decision to record revenue for the licensing agreements entered into during the class period. Thus, even though we find that Ludvigson's stock sales were too minimal to suggest insider trading, we still believe a genuine issue of material fact exists as to whether Ludvigson acted with scienter. *See Software Toolworks*, 38 F.3d at 1089 (holding that evidence that defendants participated in the drafting of documents containing false projections and that defendants knew or should have known of alleged fraud in quarterly financial statements was sufficient to defeat summary judgment on scienter issue).

E. Causation

Defendants assert that the district court's grant of summary judgment can be affirmed on a separate ground, namely that plaintiffs failed to establish "loss causation" or proximate cause. The district court rejected the "loss causation" defense in this case. We agree with that decision.

"Loss causation" is a defense for which defendants have a "heavy" burden of proof. *WOW*, 35 F.3d at 1422. To establish a "loss causation" defense at the summary judgment stage, the defendants must prove, as a matter of law, that the depreciation of the value of MIPS' stock resulted from factors other than the alleged false and misleading statements. *WOW*, 35 F.3d at 1422. Defendants have not provided enough evidence to establish as a

matter of law that they are entitled to a "loss causation" defense.

[16] Plaintiffs can establish "loss causation" by simply alleging that the false and misleading statements " 'touch[ ] upon the reasons for the investment's decline in value.' " *Id.* (quoting *McGonigle*, 968 F.2d at 821). Plaintiffs allege that the stock price was overvalued during the class period because defendants recognized revenue before it was earned and because defendants failed to disclose material information about MIPS. Plaintiffs correctly allege that soon after this information was disclosed, the price of the stock fell. Plaintiffs introduced expert testimony to establish that MIPS' revenue recognition practices "touched upon" the alleged overvalued price of the stock and that the public disclosures of the company also "touched upon" the fall in the price of the MIPS stock. Given the record before us, we believe the district court was correct in refusing to grant summary judgment on the "loss causation" defense.

F. Defendants' Cautionary Statements

The district court found that defendants' cautionary statements undercut an inference of scienter. As the district court explained: "A review of the analysts statements on MIPS through the class period show that the outlook for MIPS reflected in the market was far from overly optimistic." But as suggested above, the district court appears to have merged the "bespeaks caution" doctrine with the "truth-on-the-market" doctrine. These doctrines represent distinct legal theories. In this appeal,

the defendants argue that these doctrines provide separate grounds for affirming the district court's grant of summary judgment. We disagree.

1. The "Truth-on-the-Market" Doctrine

In a "fraud on the market" case "an omission is materially misleading only if the information has not already entered the market." *Convergent Technologies*, 948 F.2d at 513 (citing *Apple Computer*, 886 F.2d at 1114). As we have explained, "[i]f the market has become aware of the allegedly concealed information, 'the facts allegedly omitted by the defendant would already be reflected in the stock's price' and the market 'will not be misled.' " *Id.* (quoting *Apple Computer*, 886 F.2d at 1114). This principle has been termed by some courts as the "truth-on-the-market" doctrine or corollary. *See e.g., Associated Randall Bank v. Griffin, Kubik*, 3 F.3d 208, 213-14 (7th Cir. 1993); *Wielgos*, 892 F.2d at 516.[4]

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[4] The close relationship between the "truth-on-the-market" doctrine and the "fraud on the market" theory is aptly discussed by one commentator:

> Some of the cases grappling with the role of market professionals in setting stock prices have done so under the rubric of the "truth-on-the-market" doctrine, which is the flip side of the fraud-on-the-market theory. Under this doctrine, a defendant can escape liability for a false statement-or one that reveals less than the full truth-by showing that the market was not affected by the misrepresentation because the truth of the matter was known already and had been factored into market prices. The issue of

However, before the "truth-on-the-market" doctrine can be applied, the defendants must prove that the information that was withheld or misrepresented was " 'transmitted to the public with a degree of intensity and credibility sufficient to effectively counterbalance any misleading impression created by insider's one-sided representations.' " *Kaplan*, 49 F.3d at 1376 (quoting *Apple*, 886 F.2d at 1116).

The defendants bear a heavy burden of proof. Summary judgment is proper only if they show that "no rational jury could find" that the market was misled. *Kaplan*, 49 F.3d at 1376. If "the evidence presents a sufficient disagreement to require submission to the jury," summary judgment should be denied. *Id.*

[17] Here, defendants claim that information about the risky nature of MIPS' stock entered the market. In support of their position, defendants submitted 31 analyst reports and articles. According to defendants' evidence, as early as October 1990, one analyst rated the stock as "SELL." Another analyst, on February 13, 1991, recommended that MIPS be "avoid[ed]" because "technology revenues are only partially predictable."

[18] We do not think that these reports "effectively counterbalance[d]" defendants' false and misleading statements. *Kaplan*, 49 F.3d at 1376. There is no mention in

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when the truth is actually "on the market" often arises in such cases.

John M. Newman, Jr. et al., *Basic Truths: The Implications of the Fraud-On-The-Market Theory for Evaluating the "Misleading" and "Materiality" Elements of Securities Fraud Claims*, 20 J.Corp.L. 571, 576 (1995).

the reports of defendants' allegedly improper revenue recognition practices, negative forecasts, or sales decline with the R6000 line. Most of the analysts link MIPS' riskiness with the "unusual" business model[5] adopted by MIPS and the unsuccessfulness of alliances like ACE. In these circumstances, we cannot say as a matter of law that defendants have sustained their contention that the "truth-on-the-market" doctrine applies.

2. The "Bespeaks Caution" Doctrine

In granting summary judgment in this case, the district court also held that the "overall effect of defendants' [April 25 and July 31, 1991] statements was cautionary and could not be said to have misled the market." With respect to the April 25, 1991 statement, we disagree.

Summary judgment based on the "bespeaks caution" doctrine is only appropriate "when reasonable minds could *not* disagree as to whether the mix of information in the document is misleading." *Fecht*, 70 F.3d at 1082 (emphasis added). As we have explained:

> The bespeaks caution doctrine provides a mechanism by which a court can rule as a matter of law (typically in a motion to dismiss for failure to state a cause of action or a motion for summary judgment) that defendants' forward-looking representations contained enough

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[5] Under its business model, MIPS designs work stations for its microprocessors and licenses its microprocessor design to larger corporations, who develop their own computer products and work stations that compete with MIPS.

> cautionary language or risk disclosure to protect the defendant against claims of securities fraud.

WOW, 35 F.3d at 1413 (quoting Donald C. Langevoort, *Disclosures that "Bespeak Caution"*, 49 Bus.Law. 481, 482-83 (1994)).

But as we have recognized, the "bespeaks caution" doctrine is not new but a reformulation of two fundamental concepts in securities fraud law: reliance and materiality. *WOW*, 35 F.3d at 1414. "To put it another way, the 'bespeaks caution' doctrine reflects the unremarkable proposition that statements must be analyzed in context." *Id.* (citations and quotations omitted).

Thus, to determine whether the "bespeaks caution" doctrine immunizes defendants' allegedly false and misleading statements, we must analyze what, if any, cautionary statements defendants made. The cautionary statements must be "precise" and "directly address [ ] . . . the [defendants'] future projections." *WOW*, 35 F.3d at 1414 (quotations and citations omitted). "Blanket warnings that securities involve a high degree of risk [are] insufficient to ward against a federal securities fraud claim." *Id.*

[19] In this case, the alleged cautionary statements appear to be too general to trigger the "bespeaks caution" doctrine. For example, when MIPS reported its loss in the fourth quarter of 1990, MIPS warned that it "lacked visibility and . . . [was] living in an uncertain economic environment so . . . [it was] approaching the next six months with a very conservative outlook and conservative management posture." MIPS predicted that its technology licensing fees would "remain fairly flat on a year

to year basis." MIPS, however, did not disclose to the market that it was recognizing revenue before the terms of certain contracts had been negotiated, before the deliverables were shipped, and before certain contingencies were satisfied. In fact, the opposite was true. Defendants represented in its Form 10-K that "technology revenue is recognized upon the completion of contract requirements."

Defendants also contend that Ludvigson made cautionary statements during the April 25, 1991 conference call. Ludvigson's statements, however, were too general to trigger the "bespeaks caution" doctrine. Ludvigson simply stated that second quarter technology revenue was expected to "decline," that gross margin would be "flat to slightly down," and that technology revenue for 1991 "looked a lot like last year" but "he would be hesitant to put a total number on loss of revenue." Although these statements referred to MIPS' projections, there is no evidence that defendants disclosed the information that was relied upon to arrive at the internal forecast of a $4 million loss. If anything, Ludvigson's "cautionary" statements led the analysts to believe that the second quarter earnings would be similar to the first quarter earnings.

III. Costs

[20] The plaintiffs also appeal the district court's order awarding costs to defendants. Because we have reversed in part the district court's grant of summary judgment, we find that plaintiffs' appeal of the district court's order awarding costs is now moot.

CONCLUSION

As set forth above, we affirm the grant of summary judgment in favor of defendants Bennion and Jobe and reverse the grant of summary judgment in favor of defendants MIPS, Boesenberg, Miller, and Ludvigson. Because of this ruling, we find plaintiff's appeal of the district court's award of costs to be moot. Each side shall bear its own costs on appeal.

AFFIRMED IN PART, REVERSED IN PART, AND REMANDED.

APPENDIX B

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

DIANE PROVENZ; AHIKIM EIZENBERG *Plaintiffs-Appellants,* v. ROBERT C. MILLER; CHARLES M. BOESENBERG; DAVID G. LUDVIGSON; STEPHEN R. BENNION; WILLIAM D. JOBE; MIPS COMPUTER SYSTEMS, INC., *Defendants-Appellees.*	Nos. 95-15839 95-16819 D.C. No. CV-92-20159-RMW OPINION

Appeals from the United States District Court
for the Northern District of California
Ronald M. Whyte, District Judge, Presiding

Argued and Submitted
June 11, 1996 – San Francisco, California

Filed September 11, 1996

Opinion by Judge Pregerson

Before: Alfred T. Goodwin, Harry Pregerson,
and Alex Kozinski, Circuit Judges.

SUMMARY

Securities/Fraud

The court of appeals affirmed in part a district court judgment, reversed in part, and remanded. The court held, among other things, that the district court incorrectly concluded that sales of stock by a corporation's president and chairman did not support a finding of scienter in a securities fraud case, where there was evidence that the individuals traded their stock in large amounts at sensitive times.

Appellants Diane Provenz and Ahikim Eizenberg (the Plaintiffs) brought a securities fraud class action suit against appellee MIPS Computer Systems, Inc. and its officers and directors, Charles Boesenberg, Robert Miller, David Ludvigson, Stephen Bennion, and William Jobe (collectively, the Defendants). The Plaintiffs alleged that, during the class period, the value of MIPS' stock was artificially inflated because the Defendants recognized revenue before the revenue was earned and failed to disclose to the market information about MIPS' products and forecasts. The Plaintiffs case was based on a "fraud on the market" theory.

The Plaintiffs contended that, in the fourth quarter of 1990, the Defendants recognized nearly $3 million in revenue from transactions with certain entities, and that in the first quarter of 1991, the Defendants recognized $8 million in revenue from certain entities, which had not yet been earned. The Plaintiffs further contended that in the second quarter of 1991, the Defendants improperly

recognized $4.5 million in revenue. The Plaintiffs also contended that MIPS' failure to record a restructuring charge of $25.5 million before June 30, 1991 violated Generally Accepted Accounting Principles (GAAP). The Plaintiffs also contended that the Defendants' forecasts for the second and third quarters of 1991 were false or misleading.

After the Defendants filed a reply brief but before the hearing, the Plaintiffs filed a motion to strike "new" evidence contained in the Defendants' reply. The Plaintiffs also filed a supplemental declaration that rebutted the Defendants' "new" evidence. The district court denied the Plaintiffs' motion to strike the Defendants' "new" evidence and also refused to consider the Plaintiffs' supplemental declaration.

The court granted the Defendants' motion for summary judgment. The court also held that there was insufficient evidence to hold the Defendants liable for securities fraud based on scienter. The court awarded the Defendants their costs. The Plaintiffs appealed.

[1] The district court erred in not considering the Plaintiffs' supplemental declaration.

[2] MIPS' own policy, which was in existence during the class period, stated that "technology revenue is recognized upon the completion of contract requirements." [3] Intellectual property was involved, and purchase orders contained various contingencies. [4] The Plaintiffs raised genuine issues of material fact as to whether technology transfers in fact occurred during the sales process and whether such transfers were sufficient under GAAP to support the recognition of revenue. In

addition, looking at evidence in the light most favorable to the Plaintiffs, it appeared that, in certain transactions, the Defendants recognized revenue before binding agreements existed and before contract requirements were completed.

[5] Nothing suggested that the accounting decision to wait to record the restructuring charge until the third quarter violated GAAP or any of MIPS' policies. The Defendants' decision to record the restructuring in the third quarter rather than the second quarter was not actionable as a false or misleading statement.

[6] The Plaintiffs claim that certain statements made during a conference call were false and misleading was based on a MIPS internal spread sheet. [7] Ludvigson predicted a profit when MIPS had information that the company would suffer a loss. There was no evidence in the record that the Defendants disclosed to analysts the financial information upon which the internal forecast was based. The Plaintiffs raised a genuine issue of material fact as to whether the Defendants' projections for the second quarter made during the conference call were false or misleading.

[8] A jury could reasonably find that the Defendants' representation that a loss would be "small" without a restructuring charge was false or misleading given that the Defendants were projecting a $3 million loss without the restructuring charge.

[9] A jury could reasonably find that the Defendants' statements about a line were false or misleading.

[10] Based on the evidence, a jury could reasonably find that the Defendants' allegedly false and misleading statements were material and affected the total mix of information upon which a reasonable investor would have relied.

[11] The Plaintiffs did not have any direct evidence that the Defendants acted with scienter. Rather, the Plaintiffs contended that the Defendants' allegedly false and misleading statements, combined with evidence of insider trading, were sufficient to raise a reasonable inference of scienter. [12] The Defendants appeared to have violated MIPS' own policies when recognizing revenue for certain transactions. [13] The district court was wrong in resolving factual disputes which existed as to underlying transactions. The Plaintiffs provided documentary evidence that suggested that the Defendants may have recognized revenue before it was earned, and they also provided expert testimony in support of their contentions. That evidence was sufficient to overcome summary judgment. [14] There was evidence suggesting that the Defendants to disclose material information to their account. [15] According to the Plaintiffs, the individual defendants other corporate insiders sold over $8.8 million of the individual holdings during the class period. [16] The district court incorrectly concluded that the sales of stock by Miller and Boesenberg did not support a finding of scienter. There was evidence that Miller and Boesenberg traded their stock in large amounts at sensitive times. [17] However, the district court was correct in granting summary judgment in favor of Bennion and Jobe. Bennion and Jobe provided unrebutted evidence that they sold their stock for innocent reasons. [18] Even

though Ludvigson's stock sales were too minimal to suggest insider trading, a genuine issue of material fact existed as to whether Ludvigson acted with scienter. Ludvigson made many of the allegedly false and misleading statements to the analysts during conference calls, and was personally involved in and approved each decision to record revenue for licensing agreements entered into during the class period.

[19] Given the record, the district court was correct in refusing to grant summary judgment on a "loss causation" defense.

[20] Although the Defendants claimed that information about the risky nature of MIPS' stock entered the market, [21] it could not be said as a matter of law that the Defendants established the "truth-on-the-market" defense. [22] In addition, alleged cautionary statements appeared to be too general to trigger the "bespeaks caution" doctrine.

[23] The Plaintiffs' appeal of the district court's order awarding costs was moot.

COUNSEL

Jonathan K. Levine, Kaplan, Kilsheimer & Fox, New York, New York and Patrick J. Coughlin, Milberg, Weiss, Bershad, Hynes & Lerach, San Diego, California, for the plaintiffs-appellants.

Steven M. Schatz, Wilson, Sonsini, Goodrich & Rosati, Palo Alto, California, for the defendants-appellees.

OPINION

PREGERSON, Circuit Judge:

Plaintiffs Diane Provenz and Ahikim Eizenberg, on behalf of themselves and all other similarly situated purchasers of stock of MIPS Computer Systems, Inc. (MIPS), appeal the district court's grant of summary judgment in favor of all defendants. Plaintiffs brought this action against MIPS and MIPS' officers and directors, Charles M. Boesenberg, Robert C. Miller, David G. Ludvigson, Stephen R. Bennion, and William D. Jobe, under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. § 240.10b-5. The plaintiffs also appeal the district court's order awarding costs to defendants. The district court had jurisdiction under 28 U.S.C. § 1331. We have jurisdiction under 28 U.S.C. § 1291. We affirm in part, reverse in part, and remand.

BACKGROUND

The plaintiffs brought this securities fraud case as a class action. The class period runs from January 31, 1991, through October 9, 1991. Plaintiffs allege that, during the class period, the value of MIPS' stock was artificially inflated because defendants recognized revenue before the revenue was earned and failed to disclose to the market information about MIPS' products and forecasts. At the beginning of the class period, MIPS' stock traded at about $11 a share. At the high end of the class period, MIPS' stock traded at $20 5/8 a share. On October 10,

1991, the day that plaintiffs allege the fraudulently withheld information about MIPS' business and prospects entered the market, the price of the MIPS' stock declined to about $9 a share.

On June 27, 1994, the district court granted defendants' motion for summary judgment. The district court held that there was insufficient evidence to hold defendants liable for securities fraud based on scienter. The district court also awarded defendants their costs. This appeal followed.

STANDARD OF REVIEW

A grant of summary judgment is reviewed de novo. *Warren v. City of Carlsbad*, 58 F.3d 439, 441 (9th Cir.1995), *cert. denied*, 116 S.Ct. 1261 (1996). A court must view the evidence in the light most favorable to the non-moving party and draw any reasonable inferences in the non-moving party's favor. *Id.* Summary judgment is proper only if no genuine issue of material fact exists and only if the moving party is entitled to judgment as a matter of law. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986). Where material factual disputes exist, the court must allow a jury to resolve the factual disputes. *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1161 (9th Cir.1992).

ANALYSIS

I. Procedural Issues

As a preliminary matter, we must resolve two procedural issues. First, after defendants filed their reply brief but before the hearing, plaintiffs filed a motion to

strike the "new" evidence contained in defendants' reply. The plaintiffs also filed a supplemental declaration that rebutted defendants' "new" evidence. The district court denied plaintiffs' motion to strike the defendants' "new" evidence and also refused to consider plaintiffs' supplemental declaration.

[1] We believe the district court erred in not considering plaintiffs' supplemental declaration. In *Marshall v. Gates*, 44 F.3d 722, 723-725 (9th Cir.1995), we noted that Fed. R. Civ. P. 56(c) states, in relevant part, that a "party prior to the day of hearing may serve opposing affidavits." Although we interpreted this language as allowing a district court to adopt local rules that set time limits for a non-moving party to follow in opposing a motion for summary judgment, our holding in *Marshall* does not mean that defendants in this case may submit "new" evidence in their reply without affording plaintiffs an opportunity to respond. Such a result would be unfair.

We agree with the Seventh Circuit, which held that "[w]here new evidence is presented in a reply to a motion for summary judgment, the district court should not consider the new evidence without giving the [non-]movant an opportunity to respond." *Black v. TIC INV. Corp.*, 900 F.2d 112, 116 (7th Cir.1990). Thus, in resolving this appeal, we have considered both the evidence submitted by defendants in their reply and the evidence submitted by plaintiffs in their supplemental declaration.

As to the second procedural issue we must resolve, plaintiffs contend that the district court abused its discretion in denying plaintiffs' motion for reconsideration that was based on allegedly newly discovered evidence. In

their motion, plaintiffs submitted a declaration of a MIPS ex-employee. It appears, however, that plaintiffs learned about this employee well before plaintiffs filed their opposition. In these circumstances, we cannot say that the district court abused its discretion in denying plaintiffs' motion for reconsideration.

II. The Merits

To prevail on their securities fraud claims under § 10(b) and Rule 10b-5, plaintiffs must prove: (1) that defendants made a false statement or failed to disclose information that rendered another statement misleading; (2) that such statement or omission was material; (3) that plaintiffs relied on the statement or omission; and (4) that defendants acted with scienter or an intent to defraud. *Monroe v. Hughes*, 31 F.3d 772, 776 (9th Cir.1994); *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1113 (9th Cir.1989), *cert. denied*, 496 U.S. 943 (1990).

A. The Alleged False and Misleading Statements

In a securities fraud case, summary judgment is improper if a plaintiff "shows a genuine issue of fact with regard to a particular statement by the company or its insiders." *In re Worlds of Wonder Securities Litigation* ("*WOW*"), 35 F.3d 1407, 1412 (9th Cir.1994) (quotations and citations omitted), *cert. denied*, 116 S.Ct. 185 (1995) and 116 S.Ct. 277 (1995). As we have explained, "[l]iability depend[s] on the plaintiffs' success in demonstrating that one of the statements made by the company

was actually false or misleading." *In Re Convergent Technologies Securities Litigation*, 948 F.2d 507, 512 (9th Cir.1991). Thus, to determine whether summary judgment was proper in this case, we must examine each false or misleading statement allegedly made by defendants.

1. Defendant's Income Recognition Practices

Plaintiffs allege that during the class period in question defendants made false statements in MIPS' quarterly income statements when they recognized revenue before it was earned. According to plaintiffs, under Generally Accepted Accounting Principles (GAAP) and MIPS' own policies, defendants could not recognize income until a binding agreement existed, until deliverables[1] were shipped, and until material contingencies were satisfied. When revenue can be recognized is what is at issue in this case.

[2] Although defendants maintain that during the class period at issue no specific GAAP rules existed governing revenue recognition for technology licensing agreements, defendants do not appear to dispute plaintiffs' contentions that, under GAAP, revenue must be *earned* before it can be recognized. Defendants concede that, under GAAP, the earnings process must be substantially completed and an exchange must have occurred before revenue can be recognized. MIPS' own policy, which was in existence during the class period, states that

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[1] "Deliverables" include the computer tape containing programs and databases as well as the documents and manuals describing the technology.

"technology revenue is recognized upon the completion of contract requirements."

[3] That contract requirements had to be completed before revenue could be recognized as "earned" makes perfect sense given the way that MIPS and its customers structured their deals and given the fact that intellectual property was involved. The purchase orders that were signed by customers contained various contingencies, including the approval of foreign governments and the receipt of deliverables. In some instances, the terms of the licensing agreements had not yet been negotiated or finalized when customers signed the purchase orders. Although the signed purchase orders stated that the licensing fee was nonrecoverable, normally no money exchanged hands until after customers received the deliverables. As a result, MIPS had a policy of not shipping any deliverables until a binding agreement existed. Finally, the technology that customers purchased was not completed or "taped out" until March 1991. Before that date, and until MIPS' customers received the actual technology, MIPS customers had received nothing they could use.

Defendants, however, contend, and the district court agreed, that the bulk of MIPS' technology was transferred during the sales process. As the district court explained:

> The manner by which MIPS recognized revenue *appears* to have *basically* been consistent with its own written policy on the subject and GAAP. . . . The evidence indicates that while in some instances partial deliverables remained unshipped after revenue was recognized, the bulk of the terms of the technology transfers (i.e.

> transfer of sufficient technology to allow the purchaser to begin RISC utilization, payment and acceptances of nonrecoverable fees, etc.) had been substantially satisfied.

(Emphasis added.)

[4] The evidence, however, is not so clear and tells a more complicated story. We have combed through the record and are unable to determine what exactly was transferred to customers during the sales process. The technology, although licensed, had not yet been completed. If any technology was transferred during the sales process, such transfers would have been inconsistent with MIPS' policy of not transferring any technology until a binding contract had been executed. Thus, we find that plaintiffs have raised genuine issues of material fact as to whether technology transfers in fact occurred during the sales process and whether such transfers were sufficient under GAAP to support the recognition of revenue. Further, looking at the evidence in the light most favorable to plaintiffs, it appears that, in the transactions described below, defendants recognized revenue before binding agreements existed and before contract requirements were completed.

a. The Fourth Quarter for 1990

Plaintiffs contend that, in the fourth quarter of 1990, defendants recognized nearly $3 million in revenue from transactions with Sony, NEC, Control Data, Convex, and Olivetti. According to plaintiffs, had defendants not recognized this revenue, MIPS would have reported a

$2,576,000 loss rather than the $546,000 loss, that was actually reported.[2]

i. Sony

In the fourth quarter of 1990, defendants recognized $1 million in revenue from Sony based on a letter from Sony stating that it was exercising an option to purchase a license. The letter, however, stated that Sony was "agree[ing] to discuss, in good faith, the details and schedule associated with the above option during the first quarter of 1991." The discussions over the licensing agreement appear to have taken place after the income was recognized. An agreement was executed in April 1991 and provided that Sony's obligation to pay was conditioned on its receipt of all deliverables. In May 1991, Sony still had not received all deliverables.

ii. NEC

In the fourth quarter of 1990, defendants recorded $250,000 in revenue from NEC based on a signed purchase order. That purchase order contained various contingencies, none of which had been satisfied when the revenue was recognized. In addition, plaintiffs provided evidence that suggests the actual agreement may have been finalized sometime in April 1991.

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[2] Defendants reported a total revenue of $43.1 million for the fourth quarter.

iii. Control Data

In the fourth quarter of 1990, defendants recognized $250,000 in revenue from Control Data. Plaintiffs provided evidence that suggests material terms of the licensing agreement were still being negotiated when defendants recognized the revenue.

iv. Olivetti

In the fourth quarter of 1990, defendants recognized $950,000 in revenue from Olivetti. According to defendants, a binding agreement in the form of a signed letter of intent existed when the revenue was recognized. However, plaintiffs have provided documentary evidence that suggests that a binding agreement may not have been executed until after the fourth quarter ended and that Olivetti may have signed a backdated agreement. It also appears that the deliverables were not shipped until February 19, 1991.

v. Convex

In the fourth quarter of 1990, defendants recognized $450,000 in revenue from Convex based upon a December 28, 1990 agreement, which gave Convex the right to cancel and receive a full refund if MIPS failed to tape out the R4000 by December 31, 1991. There is evidence in the record that suggests the R4000 microprocessor was behind schedule. In addition, the deliverables had not yet been shipped when the revenue was recognized.

b. The First Quarter of 1991

According to plaintiffs, in the first quarter of 1991, defendants recognized $8 million in revenue from NKK, NEC, and Wang, which had not yet been earned.[3] As a result, MIPS reported a $624,000 profit for the quarter. Had defendants not recognized the alleged unearned revenue, MIPS would have recorded a loss of more than $4.3 million.

i. NKK

In the first quarter of 1991, defendants recognized $5 million in revenue from NKK based upon an agreement which was subject to approval from the Japanese government. In addition, plaintiffs contend that this agreement was subject to another material contingency, which was set out in a "side letter," which stated that MIPS was required to ship deliverables by December 31, 1991. Defendants recognized the revenue before the deliverables were shipped and before the Japanese government provided its approval of the agreement.

ii. NEC

In the first quarter of 1991, defendants recognized $2.25 million in revenue from NEC based on a purchase order for the extension of an existing licensing agreement. The purchase order, however, indicated that NEC could not formally enter into an agreement at that time.

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[3] Apparently, for the first quarter of 1991, MIPS recognized about $43 million in total revenue.

Apparently, the parties may not have reached an agreement until June 26, 1991. The June 26, 1991 agreement provided that it was not effective until executed and the Japanese government's approval obtained.

c. The Second Quarter for 1991

According to plaintiffs, in the second quarter of 1991, defendants improperly recognized $4.5 million revenue from Daewoo, NEC, and Tandem.

i. NEC

In the second quarter of 1991, defendants recognized $2 million in revenue from NEC based upon a purchase order for a joint venture with NEC called the Advanced Computing Environment ("ACE") initiative. Plaintiffs, however, provided evidence that suggests that at the time the revenue was recognized, NEC and MIPS were just beginning to negotiate the terms of the licensing agreement. In fact, as will be discussed below, ACE had not yet been announced. Thus, there is a question as to whether ACE in fact existed when the revenue was recognized.

ii. Daewoo

In the second quarter of 1991, defendants recognized $2 million in revenue from Daewoo based on an "agreement" which required the Korean government's approval before it could be considered binding. Plaintiffs' evidence shows that when the income was recognized, the terms of the licensing agreement were still being negotiated, and

the Korean government had not yet approved the agreement. In fact, the approval was not obtained until the third quarter of 1991, and only after the Korean government sought various changes to the licensing agreement.

iii. Tandem

In the second quarter of 1991, defendants recognized $600,000 in revenue from Tandem. Plaintiffs contend that a licensing agreement with Tandem was not binding when signed on June 30, 1991, because the agreement had not been finalized. Plaintiffs provided evidence that suggests drafts of the agreement were circulated as late as August and September 1991. An agreement was executed on October 1, 1991. In addition, it appears that Tandem did not execute a purchase order until November 6, 1991.

2. The Restructuring Reserve

Plaintiffs contend that MIPS' failure to record a restructuring charge of $25.5 million before June 30, 1991 violated GAAP. Plaintiffs' experts assert that defendants should have recorded the restructuring by the end of the second quarter of 1991, because at that time defendants knew a restructuring was necessary. In April 1991, MIPS and twenty other companies announced the formation of ACE, the Advanced Computing Environment initiative.

MIPS, however, waited until the third quarter of 1991 to record the restructuring charge. Apparently, defendants waited until then because MIPS had not yet made a formal decision to redirect its new product development around ACE. MIPS made this decision at the end of the

second quarter of 1991. At that time, MIPS warned that a restructuring in the third quarter would be "significant" and would cause "a loss position for the third quarter and for total year 1991."

[5] We fail to see why waiting to record the restructuring charge until the third quarter was unreasonable. In reviewing the whole record, we find nothing that suggests this accounting decision violated GAAP or any of MIPS' policies. Thus, we hold that the defendants' decision to record the restructuring in the third quarter rather than the second quarter is not actionable as a false or misleading statement.

3. Defendants' Forecasts

Plaintiffs contend that defendants' forecasts for the second and third quarters of 1991 were false or misleading. The district court rejected plaintiffs' contentions. The district court explained:

> Plaintiffs . . . have pulled isolated statements out of context. The overall effect of defendants' statements was cautionary and could not be said to have misled the market. As one analyst wrote in June 1990, "MIPS has a complex business model that is still in the process of maturing. . . . This is not a stock for the fainthearted."

By this explanation, the district court is alluding to the "bespeaks caution" doctrine and the "truth-on-the-market" doctrine, both of which have been developed by the courts as affirmative defenses to immunize defendants from liability for false and misleading statements. *See WOW*, 35 F.3d at 1413-15. Before we consider these

defenses, we must first determine whether defendants' forecasts are actionable as false or misleading statements.

A projection is a "factual" misstatement "if (1) the statement is not actually believed, (2) there is no reasonable basis for the belief, *or* (3) the speaker is aware of undisclosed facts tending seriously to undermine the statement's accuracy." *Kaplan v. Rose*, 49 F.3d 1363, 1375 (9th Cir. 1994) (citing *In re Wells Fargo Securities Litigation*, 12 F.3d 922, 930 (9th Cir. 1993) (emphasis added), *cert. denied*, ___ U.S. ___, 115 S.Ct. 295 (1994)). In this case, plaintiffs focus on various statements made during conference calls with analysts.

a. The 1991 Second Quarter Projections

In an April 25, 1991 conference call with market analysts, defendant Ludvigson, MIPS' chief financial officer ("CFO"), stated that MIPS expected technology revenues "to decline slightly from the Q1 levels" but expected "higher technology revenue performance . . . for the total year." Although Ludvigson cautioned that he "would be hesitant to put a total number on it," he suggested that MIPS' earnings for the second quarter would be similar to the $624,000 earnings reported for the first quarter. Specifically, Ludvigson stated that his "expectations for Q2 would be bottom line about Q1."

[6] Plaintiffs' claim that these statements were false and misleading is based on a MIPS internal spread sheet which predicted a loss of 17 cents per share. The spread sheet was dated April 17, 1991, eight days before the conference call. The spread sheet showed that MIPS'

internal forecasts projected a loss of $4,000,000 for the second quarter.

The district court, however, did not think that the internal spreadsheet raised a triable issue of material fact. As the district court explained:

> Plaintiffs ignore all of the other documents and testimony that put the spread sheet in context. The spreadsheet was the starting point for the discussion at the April 22-23 quarterly business review, not the quarterly forecast. The entire purpose of the quarterly business review was to develop a forecast for the quarter, known as the "QBR commitment." The QBR commitment is consistent with the general guidance given during the April 25 conference call, was distributed shortly thereafter, and was presented to the board on May 15, as a second quarter forecast. There is no evidence that the spreadsheet was other than a *preliminary* worksheet and, as such, was not something that should have been disclosed to the public. Nor does it suggest, given the way it was prepared, that defendants were hiding adverse facts.

The district court is partially correct. There is no duty to disclose internal forecasts to the public. As this court has explained, "[i]t is just good general business practice to make . . . projections for internal corporate use." *Convergent Technologies*, 948 F.2d at 516 (quoting *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1221 (9th Cir. 1980)). But we also have recognized that a company has a duty to disclose to the public internal forecasts that "[a]re made with reasonable certainty." *Convergent Technologies*, 948 F.2d at 516. We further have recognized that a company

has a duty to disclose the financial data and other material information upon which an internal forecast is based. *See In re VeriFone Securities Litigation*, 11 F.3d 865, 869 (9th Cir. 1993) ("[a]bsent allegations that [the issuer] withheld financial data or other existing facts from which forecasts are typically derived, the alleged omissions are not of material, actual facts").

[7] In this case, Ludvigson predicted a profit when MIPS had information that the company would suffer a loss. We found no evidence in the record that the defendants disclosed to analysts the financial information upon which the internal forecast was based. Further, according to the deposition testimony of MIPS' employees, the internal forecast represented "the best, most accurate representation as of the time it was prepared of what the company's financial results [would] be like for the prospective quarter." Based on this evidence, we find that plaintiffs have raised a genuine issue of material fact as to whether defendants' projections for the second quarter made during the April 25, 1991 conference call were false or misleading.

b. The 1991 Third Quarter Projections

In a July 30, 1991 press release, MIPS announced that it was going to take a "significant" restructuring charge in the third quarter. In a conference call with market analysts that same day, Ludvigson said that "the restructuring charge would be significant enough to put [MIPS] in a loss position for the third quarter and for total year 1991." Ludvigson, however, represented that, without the

restructuring charge, the loss of revenue for the third quarter would be small.

Plaintiffs contend that these statements were misleading because defendants knew that there would be a huge loss without the restructuring charge. In fact, only five days before the conference call, at the MIPS' Board of Directors meeting, defendants predicted a loss of more than $4.3 million *without* the restructuring charge.

[8] The district court, however, rejected plaintiffs' evidence and found "that MIPS' forecasts were not inconsistent with the financial information they had concerning product and service revenue." Though not inconsistent, we believe that a jury could reasonably find that defendants' representation that the loss would be "small" without the restructuring charge was false or misleading given that the defendants were projecting a $3 million loss without the restructuring charge.

4. Defendants' Omissions About the R6000 Line

Plaintiffs also allege that defendants failed to disclose that MIPS was having serious technical problems with its R6000 line. The district court, however, did not find defendants' failure to disclose this information to be misleading because the defendants had already disclosed that MIPS was having problems with its supplier. Defendants identified sourcing and cost problems with the R6000 line in their SEC Form 10-K and 10Q filings.

But a jury may find that such disclosures were not sufficient. As we have explained:

> There is a difference between knowing that any product-in-development may run into a few snags, and knowing that a particular product has already developed problems so significant as to require months of delay.

Convergent Technologies, 948 F.2d at 515, n.2 (citing *Apple Computer*, 886 F.2d at 1113-14).

[9] Here, plaintiffs have provided evidence suggesting the R6000 line was experiencing more than simply supply problems. The R6000 line was plagued with delays and performance problems so severe that MIPS was losing orders and constantly cutting sales forecasts. Defendants, however, continued to represent to analysts that there was "pretty significant demand" and that shipment levels would increase in the third quarter of 1991. Based on this evidence, we believe that a jury could reasonably find that defendants' statements about the R6000 line were false or misleading.

B. Reliance

Plaintiffs contend that defendants' alleged false and misleading statements defrauded the market by causing the price of MIPS' stock to be overvalued during the class period in question. Thus, plaintiffs' case is based on a "fraud on the market" theory. This court has recognized that where a "fraud on the market" is alleged, plaintiffs are not required to "show that they themselves actually relied on any particular misrepresentation or omission." *Convergent Technologies*, 948 F.2d at 512, n.2 (citing *Apple Computer*, 886 F.2d at 1113-14). To show reliance, plaintiffs simply must "show that they relied on the integrity of the

price of the stock as established by the market, which in turn is influenced by information or the lack of it." *Id.* Thus, in a "fraud on the market" case, "[a]n investor's reliance on the market . . . is equivalent to reliance upon statements made to the market, or the nondisclosure of material information." *Id.* Defendants do not dispute plaintiffs' allegations of reliance.

C. Materiality

In "a fraud on the market" case, a plaintiff must still establish that the false or misleading statements are material. Materiality is established by "showing that a reasonable shareholder would consider the misrepresentation or omission important, because it altered the total mix of available information." *Kaplan*, 49 F.3d at 1381 (quotations and citations omitted).

[10] Defendants do not appear to dispute that the alleged false and misleading statements were material. Nor do we think that defendants can establish that the alleged false and misleading statements were *not* material as a matter of law. As we recently stated: "Whether an omission is 'material' is a determination that 'requires delicate assessments of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact.' " *Fecht v. Price*, 70 F.3d 1078, 1080 (9th Cir. 1995) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976)). Thus, only if materiality is "so obvious that reasonable minds [could] not differ" is summary judgment appropriate. *Id.* at 1081 (quotations and citations omitted). Based

on the evidence in this case, we believe that a jury could reasonably find that defendants' allegedly false and misleading statements were material and affected the total mix of information upon which a reasonable investor would have relied.

D. Scienter

Generally, scienter should *not* be resolved by summary judgment. As we have explained:

> Cases where intent is a primary issue generally are inappropriate for summary judgment unless *all* reasonable inferences that could be drawn from the evidence defeat the plaintiff's claim. . . . However, in opposing a motion for summary judgment the plaintiff must present significant probative evidence relevant to the issue of intent, e.g. the time, place or nature of the alleged fraudulent activities; mere conclusionary allegations are insufficient to require the motion for summary judgment be denied.

Vaughn, 628 F.2d at 1220 (emphasis added). Thus, summary judgment on the scienter issue is appropriate *only* where "there is no rational basis in the record for concluding that any of the challenged statements was made with requisite scienter." *In re Software Toolworks*, 38 F.3d 1078, 1088 (9th Cir. 1994) (quotations and citations omitted).

To establish scienter, plaintiffs must show that defendants had " 'a mental state embracing an intent to deceive, manipulate, or defraud.' " *WOW*, 35 F.3d at 1424 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976)). Plaintiffs can "establish scienter by proving either

actual knowledge or recklessness." *Software Toolworks*, 38 F.3d at 1088. As we have explained, "reckless" conduct involves " 'not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.' " *Id.* (quoting *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991)).

[11] Scienter can be established by direct or circumstantial evidence. *See WOW*, 35 F.3d at 1425. Plaintiffs in this case do not have any direct evidence that defendants acted with scienter. Rather, plaintiffs contend that defendants' allegedly false and misleading statements, combined with the evidence of insider trading, is sufficient to raise a reasonable inference of scienter.

The district court, however, disagreed and held that summary judgment in favor of defendants was appropriate here because plaintiffs' evidence was insufficient to establish scienter. As the district court explained:

> If plaintiffs' [sic] papers are stripped of their harsh rhetoric they illustrate, at most, a difference of opinion as to when revenue should have been recognized. The facts do not justify a reasonable inference of fraudulent intent.

Further, according to the district court, defendants' good faith is evidenced by the fact that defendants allowed their accountant to audit MIPS' revenue recognition practices in January 1991 and January 1992. Both audits found that MIPS' accounting practices complied

with GAAP. In addition, as the district court noted, MIPS regularly consulted with their accountant each quarter to confirm that transactions were completed or sufficiently completed to allow the recognition of revenue. Thus, the district court found that MIPS' reliance on outside auditors was inconsistent with an intent to defraud.

[12] At first glance, the district court appears to be correct. As we recently stated, " '[t]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter.' " *Software Toolworks*, 38 F.3d at 1089 (quoting *WOW*, 35 F.3d at 1426). But here defendants appear to have violated MIPS' own policies when recognizing revenue for certain transactions.

[13] In addition, we agree with plaintiffs that the district court was wrong in resolving the factual disputes which exist as to the underlying transactions. Not only have plaintiffs provided documentary evidence that suggests that defendants may have recognized revenue before it was earned, they also provided expert testimony in support of their contentions. This evidence is sufficient to overcome summary judgment.

"As a general rule, summary judgment is inappropriate where an expert's testimony supports the non-moving party's case." *WOW*, 35 F.3d at 1425 (citing *Apple Computer*, 886 F.2d at 1116). Here, plaintiffs' two experts have explained in great detail how defendants' recognition of revenue for various transactions violated GAAP and MIPS' own internal policy for recognizing revenue. *See In re GlenFed, Inc. Securities Litigation*, 42 F.3d 1541, 1549 (9th Cir. 1994) (stating that under Rule 9(b) a plaintiff must

"explain[ ] why the difference . . . is not merely the difference between two permissible judgments").

Defendants, however, assert that our *WOW* decision compels an affirmance in this case. In *WOW*, the court held that plaintiffs' expert testimony was insufficient to raise a reasonable inference of scienter. 35 F.3d at 1425-1426. As the court explained, "[a]n expert's conclusory allegations that a defendant acted with scienter are insufficient to defeat summary judgment where the record clearly rebuts any inference of bad faith." *Id.* at 1426.

[14] But *WOW* is distinguishable. In *WOW*, defendants provided *unrebutted* evidence showing that their accountants had full knowledge of the disputed transactions. 35 F.3d at 1426. Here, there is evidence suggesting defendants failed to disclose material information to their accountant. If it is true that defendants withheld material information from their accountants, defendants will not be able to rely on their accountant's advice as proof of good faith. *See C.E. Carlson, Inc. v. SEC*, 859 F.2d 1429, 1436 (10th Cir. 1988) (stating that full disclosure to professional must be established to support the defense of reliance on expert opinion).

Plaintiffs also point to defendants' stock sales during the class period as evidence of defendants' bad faith. We have held that "[i]nsider trading in suspicious amounts or at suspicious times is probative of scienter." *Apple Computer*, 886 F.2d at 1117. We, however, also have recognized that "credible and wholly innocent explanations for stock sales, ranging from long-standing programs of periodic divestment, to the need to free cash to meet matured

tax liabilities, [if] . . . *unrebutted* . . . are sufficient to defeat any inference of bad faith." *Id.* (emphasis added).

[15] According to plaintiffs, the individual defendants and other corporate insiders sold over $8.8 million of their individual holdings during the class period. The district court, however, found that "neither the time nor the amount of the sales support a finding of scienter and are consistent with defendants' innocent explanations." We agree that this observation applies to some defendants but not as to other defendants.

[16] The district court incorrectly concluded that the sales of stock by Miller and Boesenberg did not support a finding of scienter. There is evidence that Miller, MIPS' chairman and CEO, and Boesenberg, MIPS' president, traded their stock in large amounts at sensitive times. Miller sold about 20% of his stock for $1,340,000. Boesenberg sold about 90,000 shares during the class period – almost six times more stock than he had sold during the twelve months preceding the class period – for $1,479,650. Both Miller and Boesenberg sold their stock shortly after the April 25, 1991 conference call but before the $4 million loss and the restructuring charge were disclosed to the public.

[17] However, we believe the district court was correct in granting summary judgment in favor of defendants Bennion and Jobe. Bennion, MIPS' vice president and treasurer, and Jobe, MIPS' president of the technology group, provided unrebutted evidence that they sold their stock for innocent reasons. Apparently, Bennion sold some shares to purchase a new home and sold the remainder of his stock when he resigned. Jobe also sold

his shares to buy a new home. Jobe sold more stock before the class period than during it.

[18] Whether defendant Ludvigson, MIPS' CFO, was entitled to summary judgment presents a more difficult question. Although Ludvigson sold only 3,265 shares during the class period, Ludvigson made many of the allegedly false and misleading statements to the analysts during the April 25, 1991 and July 31, 1991 conference calls. In addition, Ludvigson was personally involved in and approved each decision to record revenue for the licensing agreements entered into during the class period. Thus, even though we find that Ludvigson's stock sales were too minimal to suggest insider trading, we still believe a genuine issue of material fact exists as to whether Ludvigson acted with scienter. *See Software Toolworks*, 38 F.3d at 1089 (holding that evidence that defendants participated in the drafting of documents containing false projections and that defendants knew or should have known of alleged fraud in quarterly financial statements was sufficient to defeat summary judgment on scienter issue).

E. Causation

Defendants assert that the district court's grant of summary judgment can be affirmed on a separate ground, namely that plaintiffs failed to establish "loss causation" or proximate cause. The district court rejected the "loss causation" defense in this case. We agree with that decision.

"Loss causation" is a defense for which defendants have a "heavy" burden of proof. *WOW*, 35 F.3d at 1422. To establish a "loss causation" defense at the summary judgment stage, the defendants must prove, as a matter of law, that the depreciation of the value of MIPS' stock resulted from factors other than the alleged false and misleading statements. *WOW*, 35 F.3d at 1422. Defendants have not provided enough evidence to establish as a matter of law that they are entitled to a "loss causation" defense.

[19] Plaintiffs can establish "loss causation" by simply alleging that the false and misleading statements " 'touch[ ] upon the reasons for the investment's decline in value.' " *Id.* (quoting *McGonigle*, 968 F.2d at 821). Plaintiffs allege that the stock price was overvalued during the class period because defendants recognized revenue before it was earned and because defendants failed to disclose material information about MIPS. Plaintiffs correctly allege that soon after this information was disclosed, the price of the stock fell. Plaintiffs introduced expert testimony to establish that MIPS' revenue recognition practices "touched upon" the alleged overvalued price of the stock and that the public disclosures of the company also "touched upon" the fall in the price of the MIPS stock. Given the record before us, we believe the district court was correct in refusing to grant summary judgment on the "loss causation" defense.

F. Affirmative Defenses

The district court found that defendants' cautionary statements undercut an inference of scienter. As the district court explained: "A review of the analysts statements on MIPS through the class period show that the outlook for MIPS reflected in the market was far from overly optimistic." But as suggested above, the district court appears to have merged the "bespeaks caution" doctrine with the "truth-on-the-market" doctrine. These doctrines represent distinct affirmative defenses. In this appeal, the defendants argue that these doctrines provide separate grounds for affirming the district court's grant of summary judgment. We disagree.

1. The "Truth-on-the-Market" Defense

In a "fraud on the market" case "an omission is materially misleading only if the information has not already entered the market." *Convergent Technologies*, 948 F.2d at 513 (citing *Apple Computer*, 886 F.2d at 1114). As we have explained, "[i]f the market has become aware of the allegedly concealed information, 'the facts allegedly omitted by the defendant would already be reflected in the stock's price' and the market 'will not be misled.' " *Id.* However, before the "truth-on-the-market" defense can be applied, the defendants must prove that the information that was withheld or misrepresented was " 'transmitted to the public with a degree of intensity and credibility sufficient to effectively counterbalance any misleading impression created by insider's one-sided representations.' " *Kaplan*, 49 F.3d at 1376 (quoting *Apple*, 886 F.2d at 1116).

The defendants bear a heavy burden of proof. Summary judgment is proper only if they show that "no rational jury could find" that the market was misled. *Kaplan*, 49 F.3d at 1376. If "the evidence presents a sufficient disagreement to require submission to the jury," summary judgment should be denied. *Id.*

[20] Here, defendants claim that information about the risky nature of MIPS' stock entered the market. In support of their position, defendants submitted 31 analyst reports and articles. According to defendants' evidence, as early as October 1990, one analyst rated the stock as "SELL." Another analyst, on February 13, 1991, recommended that MIPS be "avoid[ed]" because "technology revenues are only partially predictable."

[21] We do not think that these reports "effectively counterbalance[d]" defendants' false and misleading statements. *Kaplan*, 49 F.3d at 1376. There is no mention in the reports of defendants' allegedly improper revenue recognition practices, negative forecasts, or sales decline with the R6000 line. Most of the analysts link MIPS' riskiness with the "unusual" business model[4] adopted by MIPS and the unsuccessfulness of alliances like ACE. In these circumstances, we cannot say as a matter of law that defendants have established the "truth-on-the-market" defense.

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[4] Under its business model, MIPS designs work stations for its microprocessors and licenses its microprocessor design to larger corporations, who develop their own computer products and workstations that compete with MIPS.

2. The "Bespeaks Caution" Defense

In granting summary judgment in this case, the district court also held that the "overall effect of defendants' [April 25 and July 31, 1991] statements was cautionary and could not be said to have misled the market." We disagree.

Summary judgment based on the "bespeaks caution" doctrine is only appropriate "when reasonable minds could *not* disagree as to whether the mix of information in the document is misleading." *Fecht*, 70 F.3d at 1082 (emphasis added). As we have explained:

> The bespeaks caution doctrine provides a mechanism by which a court can rule as a matter of law (typically in a motion to dismiss for failure to state a cause of action or a motion for summary judgment) that defendants' forward looking representations contained enough cautionary language or risk disclosure to protect the defendant against claims of securities fraud.

WOW, 35 F.3d at 1413 (quotations and citations omitted).

But as we have recognized, the "bespeaks caution" doctrine is not new but a reformulation of two fundamental concepts in securities fraud law: reliance and materiality. *WOW*, 35 F.3d at 1414. "To put it another way, the 'bespeaks caution' doctrine reflects the unremarkable proposition that statements must be analyzed in context." *Id.* (citations and quotations omitted).

Thus, to determine whether the "bespeaks caution" doctrine immunizes defendants' allegedly false and misleading statements, we must analyze what, if any, cautionary statements defendants made. The cautionary

statements must be "precise" and "directly address [ ] . . . the [defendants'] future projections." *WOW*, 35 F.3d at 1414 (quotations and citations omitted). "Blanket warnings that securities involve a high degree of risk [are] insufficient to ward against a federal securities fraud claim." *Id.*

[22] In this case, the alleged cautionary statements appear to be too general to trigger the "bespeaks caution" doctrine. For example, when MIPS reported its loss in the fourth quarter of 1990, MIPS warned that it "lacked visibility and . . . [was] living in an uncertain economic environment so . . . [it was] approaching the next six months with a very conservative outlook and conservative management posture." MIPS predicted that its technology licensing fees would "remain fairly flat on a year to year basis." MIPS, however, did not disclose to the market that it was recognizing revenue before the terms of certain contracts had been negotiated, before the deliverables were shipped, and before certain contingencies were satisfied. In fact, the opposite is true. Defendants represented in its Form 10-K that "technology revenue is recognized upon the completion of contract requirements."

Defendants also contend that Ludvigson made cautionary statements during the April 25 and July 31, 1991 conference calls. Ludvigson's statements, however, were too general to trigger the "bespeaks caution" doctrine. Ludvigson simply stated that second quarter technology revenue was expected to "decline," that gross margin would be "flat to slightly down," and that technology revenue for 1991 "looked a lot like last year" but "he

would be hesitant to put a total number on loss of revenue." Although these statements referred to MIPS' projections, there is no evidence that defendants disclosed the information that was relied upon to arrive at the internal forecast of a $4 million loss. If anything, Ludvigson's "cautionary" statements led the analysts to believe that the second quarter earnings would be similar to the first quarter earnings.

III. Costs

[23] The plaintiffs also appeal the district court's order awarding costs to defendants. Because we have reversed in part the district court's grant of summary judgment, we find that plaintiffs' appeal of the district court's order awarding costs is now moot.

CONCLUSION

As set forth above, we affirm the grant of summary judgment in favor of defendants Bennion and Jobe and reverse the grant of summary judgment in favor of defendants MIPS, Boesenberg, Miller, and Ludvigson. Because of this ruling, we find plaintiff's appeal of the district court's award of costs to be moot. Each side shall bear its own costs on appeal.

AFFIRMED IN PART, REVERSED IN PART, AND REMANDED.

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

DIANE PROVENZ and AHKIM EIZENBERG, On Behalf of Themselves and All Others Similarly Situated, Plaintiffs, v. ROBERT C. MILLER, CHARLES M. BOESENBERG, DAVID G. LUDVIGSON, STEPHEN R. BENNION, WILLIAM D. JOBE, and MIPS COMPUTER SYSTEMS, INC., Defendants.	No. C-92-20159 RMW ORDER GRANTING DEFENDANTS' MOTION FOR SUMARY JUDGMENT (Filed Jun. 27, 1994)

Defendants' motion for summary judgment came before the court on May 27, 1994. After having reviewed the parties' papers[1] and considered the oral argument of counsel, the court hereby grants defendants' motion for summary judgment. The evidence fails to raise a material issue of fact on the issue of scienter.

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[1] The court did not consider any papers which were not timely filed. Therefore, the court did not consider any papers filed following the defendants' reply brief. Further, the court is not basing its decision on statements made by declarants Kenneth Cherrstrom, Ronald Codd, and David Ludvigson as to their states of mind as set forth in their declarations filed with defendants' reply.

BACKGROUND

This is a securities fraud class action brought on behalf of all persons who purchased the stock of defendant MIPS Computer Systems, Inc. ("MIPS") between January 31, 1991 and October 9, 1991.

Plaintiffs allege that defendants' actions were designed to artificially inflate the value of MIPS stock in order to keep the company afloat and to allow defendants to sell their own stockholdings to obtain unlawful profits in violation of federal securities law. Essentially, plaintiffs allege that defendants fraudulently: 1) recognized revenue early in violation of Generally Accepted Accounting Principles ("GAAP") and MIPS' company policy regarding revenue recognition in order to portray a positive financial outlook for MIPS; 2) concealed the allegedly failing financial status of MIPS by making false and misleading statements about MIPS' products, prospects, financial results and projections; and 3) engaged in other accounting improprieties, including failing to take write-downs earlier.

During the class period, MIPS' stock traded between a high of $20^{5}/_{8}$ and a low of $8^{5}/_{8}$, the price immediately before the close of the class period. On October 10, 1991, the day by which plaintiffs' allege that all of the fraudulently withheld adverse facts about MIPS' business and prospects had become known, the price of the MIPS' stock declined by $1.50 per share, but fully recovered to its prior level within just a few days.

LEGAL STANDARD

Federal Rules of Civil Procedure, Rule 56(c), provides that summary judgment is proper when there is no genuine issue as to any material fact and when the moving party is entitled to judgment as a matter of law. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986). Defendants are entitled to summary judgment if there is a "failure of proof concerning [any one] essential element" of plaintiffs' case. *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-23 (1986). The standard for the nonmoving party is "that sufficient evidence supporting the claimed factual dispute be shown to require a jury or judge to resolve the parties' differing versions of the truth at trial." *First National Bank v. Cities Services Co.*, 391 U.S. 253, 289 (1968); *accord Anderson*, 477 U.S. at 248. The court will not "weigh the evidence," and it will view the evidence in the light most favorable to the non-moving party to determine whether there are any genuine issues of material fact for trial. . . . " *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1161 (9th Cir. 1992); *FDIC v. O'Melveny & Myers*, 969 F.2d 744, 747-48 (9th Cir. 1992).

In this case, plaintiffs' claims are based on section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. In order to prevail on their claims, plaintiffs must prove: (1) a false statement or an omission that rendered another statement misleading; (2) materiality; and (3) scienter. *See, e.g., In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1113 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990). To prove scienter, plaintiffs must prove either deliberate fraud or severe recklessness, which is defined as:

> a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 1621 (1991). There is no cause of action under the federal securities laws without a showing of scienter. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976).

Generally, scienter is not an issue which can be resolved by summary judgment:

> Cases where intent is a primary issue generally are inappropriate for summary judgment unless all reasonable inferences that could be drawn from the evidence defeat the plaintiff's claim (cite omitted). However, in opposing a motion for summary judgment the plaintiff must present a significant probative evidence relevant to the issue of intent, e.g., the time, place, or nature of the alleged fraudulent activities; mere conclusionary allegations are insufficient to require that the motion for summary judgment be denied (cite omitted).

Vaughn v. Teledyne, Inc., 628 F.2d 1214, 1220 (9th Cir. 1980).

Courts have granted summary judgment in securities fraud cases on the basis that scienter has not been shown as a matter of law. *See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1570-72 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 1621 (1991); *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1114-1119 (9th Cir. 1989) affirming summary

judgment on materiality, truth and scienter grounds); *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1218-1222 (9th Cir. 1980) (affirming summary judgment on issues of scienter and adequacy of disclosure).

Rigorous scrutiny of evidence offered in opposition to a motion for summary judgment is particularly appropriate in complex, fact specific securities fraud cases. There are many reasons. One is that fraud allegations are easily made with the 20/20 vision of hindsight after an unexpected drop in the price of a stock. The correct inquiry is whether as of the time of the alleged fraud, defendants' statements or omissions were made in bad faith given the circumstances then apparent to defendants. Another reason is that securities fraud litigation is extremely expensive and the parties should not have to incur the costs of trial if the evidence to support plaintiffs' claims is lacking. Still another is that such scrutiny is required by the mandate of Rule 56(c). This mandate requires that the court avoid the strong temptation to deny the motion merely because the task of reviewing the evidentiary material is overwhelming.

Although summary judgment is generally inappropriate when an expert's testimony supports the nonmoving parties' case, summary judgment is called for where the underlying evidence fails to support a reasonable inference of bad faith. The court is not required to defer to the conclusions and subjective contrary opinions of litigation experts formed with the vision of 20/20 hindsight. *See: In re Adobe Systems, Inc. Securities Litigation*, 787 F. Supp. 912, 919 (N.D. Cal. 1992).

ANALYSIS

1. Accounting Practices

a. Revenue Recognition

Plaintiffs' main argument is that defendants "cooked the books, knowingly causing MIPS to report materially false revenues and earnings. Defendants knowingly caused MIPS to violate its own revenue recognition policy and Generally Accepted Accounting Procedures ("GAAP")." If plaintiffs papers are stripped of their harsh rhetoric they illustrate, at most, a difference of opinion as to when revenue should have been recognized. The facts do not justify a reasonable inference of fraudulent intent for a number of reasons as discussed below.

"(G)enerally accepted accounting principles are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions . . . [and instead] tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management." *Thor Power Tool Co. v. Commissioner Revenue*, 439 U.S. 522, 544 (1979). *See* Accounting Principles Board (ABP) Opinion No. 22, para. 5 ("Applying generally accepted accounting principles requires judgment be exercised as to the relative appropriateness of acceptable alternative principles and methods of application in specific circumstances of diverse and complex economic activities").

MIPS' technology revenue recognition practices were audited by Ernst & Young, a nationally recognized accounting firm, in January 1991 (1990 audit) and January 1992 (1991 audit) and, on both occasions, it found that MIPS' accounting complied with GAAP. During MIPS'

life as a public company, Ernst & Young never reversed or required restatement of a prior or current fiscal period. Further, MIPS voluntarily consulted with Ernst & Young about technology licensing transactions during every quarter at issue in order to confirm what transactions were completed or sufficiently complete to allow the recognition of revenue. MIPS' reliance upon the guidance of outside auditors is inconsistent with the intent to defraud. *See: S.E.C. v. Steadman*, 967 F.2d 636 (D.C. Cir. 1992). This is particularly true here where MIPS followed Ernst & Young's advice and recognized on several occasions less revenue than its controller originally believed should be recognized. On one of these occasions, MIPS knew that following its accountant's advice would result in a loss for the quarter rather than a profit. (Recognition of revenue from the NEC-ICE purchase order in July 1991).

The fact that income was fully realized from the transactions for which plaintiffs claim revenue was recognized early negates an inference of scienter. The deals were "real deals" – the transaction closed and MIPS was paid. MIPS' customers were large corporations such as NEC, Toshiba, Microsoft, and Olivetti who were buying rights to exploit future technology. Of the nearly $40,000,000 in technology revenue recorded during 1991, all but about one percent was paid and the one percent was fully reserved. The only revenue not collected was owed by Wang, an eventual bankrupt. It is noteworthy that plaintiff's voluminous papers are essentially void of evidence from MIPS' customers suggesting that MIPS had not earned the revenue by the dates on which it was

recognized or that MIPS had not substantially accomplished what it had to do to be entitled to the benefits represented by the revenue. If MIPS were fraudulently or recklessly recognizing revenue early, common sense would suggest that an unusually high percentage of that revenue would not have been collected. Further, plaintiffs could surely have provided evidence from MIPS' customers that MIPS had not earned the revenue from them by the time MIPS recognized the revenue on its financial statements.

The manner by which MIPS recognized revenue appears to have basically been consistent with its own written policy on the subject and GAAP. The document plaintiffs' own expert Ms. Gleitsmann relied upon for authoritative accounting information states: "Revenues are not recognized until earned. Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues." Exhibit B, pg. 1084 to Gleitsmann's declaration. MIPS' policy and the actions of MIPS' controller and the defendants did not significantly vary from the above teaching. The evidence indicates that while in some instances partial deliverables remained unshipped after revenue was recognized, the bulk of the terms of the technology transfers (i.e., transfer of sufficient technology to allow the purchaser to begin RISC utilization, payment and acceptance of non-recoverable fees, etc.) had been substantially satisfied.

The court will not in this order discuss each of the transactions questioned by plaintiffs, but will address a few to illustrate its conclusion.

Plaintiffs argue that certain licensing revenue was recognized prematurely because MIPS had not yet obtained foreign governmental approval of the transactions and, therefore, the contracts were not binding until such approval was obtained. It is undisputed that in each case governmental approval was granted and that MIPS was paid 100% of what was owed. The issue is whether governmental approval was a material contingency to the earnings process. MIPS believed at the time it recognized the revenue that the governmental approval process was a ministerial act and therefore the potential for non-approval was remote. The facts offered by plaintiffs do not raise a disputed issue of material fact as to MIPS' good faith in treating the approval process as ministerial. Thus, MIPS was not acting fraudulently in recognizing revenue pending governmental approval.

Plaintiffs argue that MIPS acted fraudulently in treating purchase orders from NEC as binding agreements and recognizing revenue based upon the submission of the purchase orders. However, this argument ignores the plain language of the purchase orders and the fact that Ernst & Young approved revenue recognition. Both purchase orders state explicitly that NEC "agrees" to pay a "non-recoverable license fee" in exchange for MIPS' grant of the license and were executed by the head of NEC's semi-conductor division Dr. Sasaki, before the end of the relevant quarter.

Plaintiffs also claim that MIPS' recognition of revenue from agreements that were later amended show "scienter". However, the evidence does not establish that MIPS did not reasonably believe that the contracts were binding when made. For example, plaintiffs contend that

an amendment to a prior software license to Tandem was not binding when signed on June 30, 1991 as it was amended again on September 30. However, evidence shows that even the Tandem vice president who signed the agreement considered it binding as of June 30, 1991.

Plaintiffs argue that defendants acted fraudulently when revenue was recognized from technology licensing agreements prior to the transfer of the "deliverables" under those agreements. No accounting literature in effect during the class period explicitly addressed revenue recognition under technology licensing agreements. The key elements in the earning process were getting the customer to commit to the MIPS RISC architecture by signing a licensing agreement, getting the customer to commit to paying a license fee, and from the customer's standpoint, obtaining the authorization to exploit the technology. It is important to remember that what customers were buying was the right to use a developing technology and not some packaged product. Further, the market clearly knew that MIPS was recognizing R4000 license revenue before the R4000 taped out (delivery of final design information to chip manufacturers) and was commercially available. Plaintiffs' evidence fails to raise a material question as to whether defendants in bad faith recognized revenue before they did what they were required to do to earn the income under their various technology licensing agreements.

b. Restructuring

Plaintiffs contend that MIPS failed to timely record a restructuring reserve as of June 30, 1991, by which time it

allegedly knew a restructuring charge needed to be recorded. In April of 1991, MIPS and twenty other companies announced the formation of the ACE Initiative ("ACE"). ACE was an alliance of companies which agreed to design and manufacture computers and software based around the R4000 and the Intel x86 microprocessors. MIPS' restructuring took place in the third quarter of 1991 after MIPS' July 1991 decision to redirect its new product development around ACE and to reduce costs. MIPS warned that the write-downs would be "significant" and mean "a loss position for the third quarter and for total year 1991." Exhibit 21 at 8-9. Plaintiffs' expert Rossi concludes that write-downs should have been taken as early as the fourth quarter of 1990, before the ACE initiative was even announced. His conclusions, however, are classic examples of ones made in hindsight and not ones based upon the contemporaneous circumstances known to defendants. No reasonable inference can be drawn that defendants delayed the restructuring or the announcement of it with the intent to defraud the public. No reasonable inference can be drawn that MIPS' accounting and business judgments were fraudulent.

c. Miscellaneous Accounting Issues

Plaintiffs quibble with other accounting practices by MIPS. None of these suggests that MIPS acted in bad faith. At most, the declarations of plaintiffs' accounting experts show that accounting judgments can differ.

2. Defendants' Public Statements

Plaintiffs claim that defendants lied about expected quarterly earnings during the class period. Plaintiffs, however, have pulled isolated statements out of context. The overall effect of defendants' statements was cautionary and could not be said to have misled the market. As one analyst wrote in June 1990, "MIPS has a complex business model that is still in the process of maturing. . . . *This is not a stock for the fainthearted.*"

The plaintiffs' claims, however, focus on statements made in an April 25, 1991 conference with market analysts and in a July 30, 1991 press release.

In the April 25, 1991 conference call defendant Ludvigson, MIPS' Chief Financial Officer, stated that MIPS expected technology revenue "to decline slightly from the Q1 levels." When asked again about technology revenue, he said he was looking "to a higher technology revenue performance . . . for the total year," but cautioned that he "would be hesitant to put a total number on it." Representations such as this are simply not specific enough as a matter of law to show fraud.

Plaintiffs argument that this statement was fraudulent relies on a spread sheet dated April 17, 1991 that was prepared for discussion at MIPS' quarterly business review and predicts a loss of 17 cents per share. Plaintiffs claim this proves that MIPS believed on April 17 that it would lose $4,000,000 in the second quarter. Plaintiffs ignore all of the other documents and testimony that put the spreadsheet in context. The spreadsheet was the starting point for the discussion at the April 22-23 quarterly business review, not the quarterly forecast. The entire

purpose of the quarterly business review was to develop a forecast for the quarter, known as the "QBR commitment." The QBR commitment is consistent with the general guidance given during the April 25 conference call, was distributed shortly thereafter, and was presented to the board on May 15, as a second quarter forecast. There is no evidence that the spreadsheet was other than a preliminary worksheet and, as such, was not something that should have been disclosed to the public. Nor does it suggest, given the way it was prepared, that defendants were hiding adverse facts.

In the July 30, 1991 press release, MIPS announced that it was going to take a "significant" restructuring charge in the third quarter. In a conference call with market analysts that same day, Ludvigson said that the restructuring would "be significant enough to put us in a loss position for the third quarter and for total year 1991." The market was not misled. Plaintiffs claim that defendants misled the market because before the announcement MIPS knew it was going to experience a loss even without the restructuring charge. However, the evidence establishes that MIPS' forecasts were not inconsistent with the financial information they had concerning product and service revenue. The fact that a future prediction turns out to be wrong does not mean it was fraudulent when made. *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489-90 (9th Cir. 1974).

Cautionary statements such as those made by MIPS bespeak caution and undercut an inference of scienter. A review of the analysts statements on MIPS through the class period show that the outlook for MIPS reflected in the market was far from overly optimistic.

3. Problems with the R6000 Line

Plaintiffs allege that defendants committed fraud by failing to reveal problems that MIPS was having with its R6000 line. Specifically, plaintiffs contend that defendants failed to disclose "quality" problems as opposed to "supply" problems, which were admittedly revealed.[2] Plaintiffs point to internal MIPS memoranda which discuss the problems with the R6000 line as evidence that defendants knew the products were essentially useless and unprofitable. Defendants counter by arguing that the market was fully aware of the R6000 lines problems (via MIPS' relevations as well as other sources), and that, therefore, no person could have been misled about the product line.

The evidence supports defendants' contention. In the February 5, 1991 analysts conference call, Ludvigson said that MIPS had "unshipped orders" because of supply problems. In their SEC Form 10-K and 10-Q filings, defendants discussed sourcing and cost problems the company was having with the R6000 line. That the R6000 line may have also had other "technical" problems that were not specifically identified by defendants is not significant and, in any case, are largely unsubstantiated.

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[2] The court notes that plaintiffs allegations in this area rest almost completely on the expert testimony of Mr. Mendiones. However, as the parties are aware, the court has determined that plaintiffs failed to disclose him as an expert in a timely manner, thus precluding use of his testimony for all purposes except rebuttal or impeachment. *See* order of May 4, 1994. Consequently, plaintiffs allegations regarding the R6000 are essentially unsubstantiated by admissible evidence.

4. Insider Sales

Plaintiffs contend that the individual defendants' sales of MIPS' stock during the class period support their scienter assertion. "Insider trading in suspicious amounts or at suspicious times is probative of bad faith and scienter." *In re Apple Computer Securities*, 886 F.2d 1109, 1117 (9th Cir. 1989). However, the pattern of stock trading and uncontradicted deposition testimony showing innocent explanations for the stock sales, such a program of periodic divestment and the need to free funds to meet tax liabilities, may defeat any inference of bad faith. *Id.* In the instant case, neither the time nor the amount of the sales support a finding of scienter and are consistent with defendants' innocent explanations.

Defendant Miller, MIPS' Chairman and CEO, sold stock during the class period on May 2 and May 3, 1991. He sold 75,000 shares, which was roughly 20 percent of the stock he either owned or in which he had fully vested rights. Later that month, Miller exercised an option and bought another 50,000 shares. Options for 43,500 more shares vested in late June and early July. Thus, during the third quarter, Miller owned 242,285 shares and was fully vested in 113,500 options and did not sell any of his stock.

Defendant Boesenberg, MIPS President, sold stock roughly every six months after it vested.

Defendant Bennion, MIPS Vice President and Treasurer, sold shares in connection with his purchase of a new home. He resigned from MIPS effective September 17, 1991, under the Voluntary Severance Incentive Plan which included the accelerated vesting of up to one

year's future options. Like other employees who voluntarily took severance, Bennion exercised his options and sold his stock upon leaving the company.

Defendant Jobe, MIPS President of the Technology Group, sold more stock before the class period than during it. He resigned his position during the class. He also indicated that he sold shares to enable him to finance the purchase of a new home.

Defendant Ludvigson, MIPS' Chief Financial Officer and under plaintiffs' theory, one of the chief architects of "the massive fraud," sold only 3,265 shares of stock during the class period. He had sold 5,000 shares in May of 1990 before the class period.

In summary, the court does not find that there was insider trading in suspicious amounts or at suspicious times which can reasonably lead to an inference of bad faith.

CONCLUSION

For the reasons stated above, it is hereby ordered that defendants' motion for summary judgment is granted.[3]

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[3] Defendants contend in their moving papers that plaintiffs have failed to show "loss causation" (i.e. proximate cause). The court does not find this portion of defendants' argument persuasive. Defendants assert that plaintiffs have not produced evidence that any misrepresentations or omissions led to a decline in the value of MIPS stock. The recoverable damage is "the difference between the purchase price and the value of the stock at the date of purchase." *Wood* [sic] *v. Tandem Computer, Inc.*, 818 F.2d 1433, 1437 (9th Cir. 1987). Thus, it is conceivable that

DATED: 6/27/94

/s/ Ronald M. Whyte
RONALD M. WHYTE
United States District Judge

Copy of Order mailed on JUN 27 1994 to:

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defrauded plaintiffs could be successful even if a stock price never declined (although such plaintiffs might have a problem establishing damages if they could "recoup" their loss by selling at an equally inflated cost). Here, plaintiffs allegedly purchased at an inflated price which was set by the market based on false financial statements. If the price was inflated and the market valued the stock based in part upon defendants' financial statements, loss causation is established (i.e. it was a direct or probable consequence of defendants' incorrect financial statements that the market inflated the value of the stock and investors bought at the inflated price.) However, since the court finds that even if MIPS' financial statements were false or misleading (which is at best questionable) there is no evidence of "scienter", the loss causation issue is of no consequence.

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APPENDIX D

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

DIANE PROVENZ; AHIKIM EIZENBERG, Plaintiffs - Appellants, v. ROBERT C. MILLER; CHARLES M. BOESENBERG; DAVID G. LUDVIGSON; STEPHEN R. BENNION; WILLIAM D. JOBE; MIPS COMPUTER SYSTEMS, INC., Defendants - Appellees.	Nos. 95-15839, 95-16819 D.C. No. CV-92-20159-RMW ORDER (Filed Feb. 4, 1997)

Before: GOODWIN, PREGERSON, and KOZINSKI, Circuit Judges

Appellants' motion to strike appellees' second petition for rehearing and suggestion for rehearing en banc is denied.

The panel as constituted in the above case has voted to deny the second petition for rehearing. Judges Pregerson and Kozinski voted to reject the suggestion for rehearing en banc and Judge Goodwin would so recommend.

The full court has been advised of the suggestion for rehearing en banc and no active judge of the court has requested a vote on it. Fed. R. App. P. 35.

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

APPENDIX E

ER164/J

* * *

BACKGROUND

3. The FASB encouraged the American Institute of Certified Public Accountants (AICPA) to develop this proposed SOP from a 1987 AICPA issues paper, *Software Revenue Recognition.*

4. Although FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* provides guidance on when to recognize revenue in general, the authoritative literature provides no specific guidance on when to recognize revenue on licensing or leasing arrangements, sales, or other marketing arrangements for computer software. Some authoritative literature and industry practices may be useful for guidance by analogy, but applying general guidance to software transactions can be difficult because at least some of it was developed to apply to sales of tangible products.

5. The financial statements of publicly held companies indicate a wide range of revenue recognition practices. It is difficult to determine the extent to which the diversity represents diverse application of generally accepted accounting principles (GAAP) in the same circumstances. It appears that at least some similar transactions are being accounted for diversely; however, the variety of ways in which software is licensed or sold, as discussed in the following section, also contributes to the apparent diversity.

* * *

* * *

27. Proponents observe that it is unlikely that a software vendor would fail to deliver software that is deliverable once a contract is signed. They further point out that the contract grants the licensee the right to use the software and to enforce delivery by the licensor. Also, all costs to produce and market the product have been incurred by then, so that delivery is not a key event in the vendor's earnings process. Further, they believe delivery may be subject to management's discretion. For example, management may contact customers and ask them to accept or defer delivery, thereby controlling the timing of revenue recognition. They believe an objectively determinable exchange occurs at contract signing, namely, the exchange of an obligation to deliver the software for a promise to be paid a licensing fee.

28. Some also argue that the measurement of economic earnings should be the focus of the discussion and that the objectives of financial reporting are not served when reported earnings do not present the economics of the company's earnings process. They observe that under FASB Statement No. 86, much of the cost incurred to develop software is charged to expense when incurred. Thus, the longer revenue recognition is delayed, the more likely that revenues would not be matched soundly with costs and that reported earnings would be a conglomeration of unrelated revenues and expenses.

* * *

ER164/I

* * *

Background

.04 The FASB encouraged the American Institute of Certified Public Accountants (AICPA) to develop this statement of position from a 1987 AICPA issues paper, *Software Revenue Recognition.*

.05 Although FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* provides guidance on when to recognize revenue in general, authoritative accounting literature provides no specific guidance on when to recognize revenue on licensing, selling, leasing, or otherwise marketing computer software.

.06 At this SOP's printing, the financial statements of publicly held companies indicated a wide range of revenue recognition practices. It is difficult to determine the extent to which that wide range represented diverse application of generally accepted accounting principles (GAAP) in the same circumstances. It appeared that at least some similar transactions were being accounted for diversely; however, the variety of ways in which software is licensed or sold, as discussed in the following section, also contributed to the apparent diversity.

* * *